

THE FINANCIAL STRENGTH OF THE FEDERAL HOUSING ADMINISTRATION

HEARING BEFORE THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE RESULTS OF THE PRICE WATERHOUSE ACTUARIAL ANALYSIS, TO
RECEIVE THE GENERAL ACCOUNTING OFFICE'S AUDIT OF FHA'S FI-
NANCIAL CONDITION, AND TO HEAR THE ADMINISTRATION'S RECOM-
MENDATIONS FOR ACTION TO REBUILD THE LONG-TERM FINANCIAL
SOUNDNESS OF FHA

JUNE 6, 1990

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CONTENTS

WEDNESDAY, JUNE 6, 1990

Opening statement of Senator Cranston	Page 1
Opening statements of:	
Senator Riegle.....	5
Senator Garn.....	7
Senator Pressler	8

WITNESSES

Jack Kemp, Secretary, Department of Housing and Urban Development, Washington, DC, accompanied by John Weicher, Assistant Secretary for Policy Development and Research, and Mary Burnett	9
Prepared statement	16
John Ols, Jr., Director, Housing and Community Development Issues, U.S. General Accounting Office, Washington, DC, accompanied by Jay Cherlow ...	50
Prepared statement	52
Summary	54
Background	58
GAO's analysis of MMI fund position.....	58
FHA policy options.....	59
Impact under less optimistic economic forecasts.....	67
Views on what FHA's role in the housing market should be	68
FHA's management problems.....	71
Exhibits:	
I. Summary of policy options by economic scenario, end of fiscal year cash balance.....	74
II. 1998 end of year cash position	75
III. Summary of economic variables.....	76
IV. Median home prices by State (1988).....	77
James Waddell, partner, Price Waterhouse, office of government services, Washington, DC, accompanied by Thomas Craren, Samuel Gutterman, and Patrick Hendershott	78
An actuarial review of the Federal Housing Administration's Mutual Mortgage Insurance Fund	97

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WEDNESDAY, JUNE 6, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Alan Cranston (chairman of the subcommittee) presiding.

Present: Senators Cranston, Riegle, Graham, D'Amato, Garn, Pressler, and Mack.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. The hearing will please come to order.

I welcome all of you to the fourth hearing on the financial strength of the FHA mortgage insurance funds. I particularly welcome you, Mr. Secretary.

Secretary KEMP. Thank you, Mr. Chairman.

Senator CRANSTON. This morning's hearing will concentrate on FHA's Mutual Mortgage Insurance Fund—America's flagship source of assistance to moderate- and middle-income homebuyers. This is a long-awaited opportunity for Senators finally to learn the results of the Price Waterhouse actuarial analysis, to receive the General Accounting Office's audit of FHA's financial condition, and to hear the administration's recommendations for action to rebuild the long-term financial soundness of FHA.

Three years ago, this subcommittee began a sweeping review of Federal housing policy. That effort brought a remarkably enthusiastic and thoughtful response from leaders across the country who care about housing in America. Virtually every one who participated recognized that FHA has been one of our country's great public achievements.

FHA is the foundation stone of home finance in this country. FHA insures nearly 700,000 mortgages a year. FHA today insures a total of \$271 billion in home mortgages, \$114 billion insured since 1986. FHA is increasingly needed by first time homebuyers—in the first quarter of this year, over 80 percent of all first time homebuyers relied on FHA mortgages.

Just as FHA revolutionized mortgage lending 50 years ago, it is still vitally needed today by American families seeking the American dream of homeownership.

During the past year, attention has focused on the Reagan-era scandals in HUD's Mod Rehab Program. Abuses in that program pale in comparison to the damage that was done to FHA during those sorry years: failure to modernize FHA's management and policies; hare-brained schemes to dismantle FHA and sell it off; demoralization of FHA staff; and the launching of new practices, such as coinsurance, with scandalous failure to monitor the very huge risks involved in all of this.

No task before this subcommittee and before the HUD Secretary is more important than correcting the damage that was done and rebuilding the financial strength of FHA.

The subcommittee's 3-year review of housing policy has produced the National Affordable Housing Act—major, bipartisan legislation that is about to go to the Senate floor. The full Banking Committee approved the bill with a vote of 16 to 4. The committee report will be filed within a few hours, before dusk tonight, and the Senate Majority Leader has assured me that the housing bill is one of the four top priorities for action in this session of Congress.

A key purpose of the National Affordable Housing Act is to expand homeownership opportunities for all Americans, particularly for first time homebuyers, many of them young people starting their families. I have made it clear that I am determined to make sure that any new legislation will build FHA's financial strength so that FHA can serve this generation of young families as it did their parents and grandparents.

That is why I and other Senators have been so eagerly awaiting—and for a long time awaiting—the results of the Price Waterhouse actuarial analysis. We had hoped to receive the report early this year. Then we hoped to get it in March. Then we hoped to get it prior to committee mark-up in May. The repeated delays forced the committee reluctantly to remove most provisions relating to FHA and homeownership from the National Affordable Housing Act.

I'm sure the delays have made it possible for us to have a better product and better guidance for changes in policy. At least I hope that's the case. I look forward to hearing the report and Secretary Kemp's recommendations this morning.

Jack, I want to help you succeed in improving FHA. I assure you that this subcommittee—members on both sides of the table—want to work with you cooperatively to rebuild your department and to achieve sound housing policies that you and we can all be proud of.

I suspect that this committee has a much greater desire to work with you and to help you succeed than is realized in some parts of the administration.

But if we are going to work together for the public good, the committee is going to have to be given information that is needed to make sound decisions. I understand that the administration's policy recommendations have been the subject of negotiation between OMB and HUD and others in the administration. And I see you nodding your head in agreement with that speculation.

Secretary KEMP. Yes, I do agree with that.

Senator CRANSTON. I understand that some issues remained unresolved as of yesterday. That is understandable—these are sensitive matters of great consequence.

It is, however, deeply disappointing, and I stress my deep disappointment over one aspect of this, that the administration—even late yesterday afternoon—was refusing to permit Price Waterhouse to help Senators prepare for this meeting. The committee did not ask for advanced information on the administration's recommendations; we sought, however, only a technical background briefing on an actuarial study of great importance to members—a study that was completed some time ago.

Such a briefing would have made this morning's hearing a much more useful exchange of information. The decision to withhold that information from Senators in preparation for this hearing seems even harder to understand this morning, when we read in the Washington Post information, it all appeared here, that was withheld from Senators, made available to the press.

You know, Jack, what happened yesterday between you and me in this matter. Just yesterday.

Secretary KEMP. I do, Mr. Chairman.

Senator CRANSTON. And what did not happen yesterday. If we're going to work together as effectively as I want and as effectively as I believe you want, we can't have more of this.

Incidentally, the rules of the committee state that any witness appearing before the committee or subcommittee, including any witness representing a Government agency, must file with the committee or subcommittee 24 hours preceding his appearance, 120 copies of his statement to the committee or subcommittee. And the statement must include a brief summary of the testimony.

In the event that the witness fails to file a written statement or brief summary in accordance with this rule, the chairman of the committee or subcommittee has the discretion to deny the witness the privilege of testifying before the committee or subcommittee until the witness has properly complied with the rules.

I think we should abide by the rules in our mutual relationship. I'm obviously not going to invoke that and refuse to hear the testimony until we can prepare better to hear it, because I do want us to move ahead. But I'm disappointed that we arrive at this situation today.

Similar to this is my effort to get some indication of the administration's view of the housing bill. It was indicated some time ago that we would get that rather soon. We did not. It has been indicated that we will get that this week, and I trust that will happen.

Not much time remains for legislative action in this session of Congress. If we work together effectively and cooperatively, I'm sure we can take action to strengthen FHA in conjunction with the Senate floor action on the National Affordable Housing Act.

We're going to bring that up soon. If we don't get the word from the administration, we're going to have to go ahead with it. I hope we can crank in some resolution of the FHA problem.

I do not believe that Congress should act on FHA in haste and without having all the information we need to make as sound decisions as we can.

FHA is simply too important to be subjected to quick-fixes and policy changes that are not carefully considered. Senators have responsibility for making sure that actions on FHA will actually im-

prove the long-term actuarial soundness of the fund and serve the interests of America's homebuyers.

I look forward to hearing your testimony, Jack, and the testimony of our other witnesses. I hope we can work together to put FHA on a sound footing.

I now yield to my colleague and friend who is the ranking minority member of the committee, the distinguished Senator from New York, Mr. D'Amato.

Senator D'AMATO. Mr. Chairman, in the interest of time, I'm not going to read my entire statement but I will take the time out, if I might, to simply read the conclusion and summarize it. If FHA reforms are needed, then let's get them out on the table as quickly as possible, so that we can deal with them in a manner that will prevent the debacle that we have seen as it relates to the S&L's.

Let's not come forward with legislation which is designed and intended to take away the necessary flexibility because I certainly believe that that's what we've done with FIRREA. And we can't get the administration's representatives, with the exception, I might say, of the Secretary—

Secretary KEMP. Thank you.

Senator D'AMATO [continuing]. Who is here before us, to indicate that there should be additional flexibility that could possibly do two things—preserve housing, make it available, and keep taxpayers from having to pick up a bigger share of the burden.

I am absolutely convinced that there are at least four or five different legislative proposals that could save the taxpayers billions, and we are literally seeing this money just dissipate on a daily basis.

I hope that we can avoid that kind of debacle. And I hope that we can make the kinds of reforms that may be necessary without creating a panic by doing it in the soundest method possible. And that's going to require us to get the facts out and not have members of the Congress take the legislative agenda and say that these things will never take place, and create the kinds of problems such as forcing the sale of assets that shouldn't be dumped on the market, that we've seen result from, I think, intemperate responses on our part.

So I hope that we think about the taxpayers, think about the consequences and don't look for those big headlines which tend to work against the best interests of the taxpayers in many cases.

That's what I hope we can do and that's going to require the administration to deal with us, as the Chairman has indicated, in a forthright manner.

Thank you, Mr. Chairman.

Senator CRANSTON. Senator Riegle.

Senator RIEGLE. Thank you, Senator Cranston.

I want to ask also that my full statement be made a part of the record.

STATEMENT OF SENATOR DONALD W. REIGLE, JR.

I would like to commend my colleagues, Senator Cranston, chairman of the Housing Subcommittee, and Senator D'Amato, the ranking Republican member of the Housing Subcommittee, for conducting this hearing on the financial stability of the Federal Housing Administration [FHA]. This is a very important issue as we grapple with the housing crisis confronting this Nation and the need to ensure the fiscal responsibility of Government programs.

The Federal Housing Administration single family mortgage insurance program was created to encourage lenders to make loans to low- and moderate-income individuals and to first time homebuyers so that they could afford to purchase their homes. The program has been successful in fulfilling this objective. However, some very serious concerns have been raised regarding the financial stability of the fund and its ability to continue to perform its mission.

According to GAO and Price Waterhouse from the mid 1980's to 1987, the overall FHA equity was reduced from \$3.1 billion to \$1.2 billion and \$1.1 billion of the loss was attributable to a change in the incorrect accounting principles formerly used by FHA. The remainder of the losses represented actual losses suffered by the fund.

In the recent HUD Inspector General's Report to the Congress, the Inspector General's audits indicated that problems continue to plague the stability of FHA.

This morning I look forward to hearing the findings of the long awaited Price Waterhouse and GAO reports on the financial soundness of the FHA programs. I am particularly interested in hearing recommendations for refinements to the programs which will enhance their financial stability. This is a very important concern. We also must remain mindful of the mission of FHA—to expand homeownership opportunities for low- and moderate-income Americans.

All Americans deserve a decent place to live and the opportunity to own their home. A few weeks ago we reported out of the Banking Committee a comprehensive housing bill to bring about these goals. The FHA programs are an essential element in the effort to achieve these goals and to assure that low- and moderate-income Americans, in particular, have the opportunity to achieve homeownership. The FHA must remain financially strong to fulfill its mission.

The results of the studies which will be presented today have been long awaited. We can now begin to carefully consider the issues raised by the reports. If refinements to the programs are needed, they must be analyzed and considered in order to craft long-term strategies to assure the soundness of the fund. I look forward to working closely with the Housing Subcommittee and the administration to achieve appropriate solutions.

Senator RIEGLE. And I want to commend you, Senator Cranston and Senator D'Amato, the ranking member of the subcommittee, for plowing ahead on this issue and all of the other housing-related questions.

Time is short. We really have to move quickly on the housing bill. You and I have spoken about that just this morning in passing, Mr. Secretary. Time is really of the essence in moving that without any further delay.

I want to just indicate, too, that there's a general concern about the fact that we were not able to get this study until literally minutes ago, so we were not able to be briefed on it or to have the chance to draw from it the way we would normally want to do and be able to do to have this kind of a hearing.

You've indicated to me that you had no part in having this released to the newspaper. I mean, we all read about it this morning in the Washington Post. Somebody turned it loose. I don't know if it was in OMB or whoever. But I think it really sets us back, in a sense, in terms of our ability to basically think through what needs to be done together.

So I would hope that the signal would go out throughout HUD, and I'm sure you'll send it out because you're an experienced signal-caller, to let people know that we really need to be on all

fours in terms of sharing this information on a timely basis so that we can really think together and work together.

You know that you have great regard personally among the members of this committee, and certainly including this Chairman. We've done a lot of things together and we'll do a lot of things together in the future. But it's important, very important that this information get to us before it gets to the newspapers, especially so that we can prepare properly.

And you may want to make some comment on that at an appropriate point.

But in terms of the quick look we've been able to give this, according to the GAO and to Price Waterhouse, from the mid-1980's to 1987, the overall FHA equity was reduced from \$3.1 billion to \$1.2 billion and \$1.1 billion of the loss was attributable to a change in the accounting principles that were formerly used by FHA, and the remainder of the losses represented actual losses suffered by the fund.

The recent HUD Inspector General's report to the Congress indicated that problems continue to plague the stability of the FHA.

What I'm concerned about here, and the thing we have to be very careful that we pin down, is whether or not we're reporting operating results now that, when you take and look over the full term of the exposure to the Government, would be inflated, would not be accurate, would not be borne out by the actual experience as the years go by.

I am determined, speaking as the Chairman of the full committee, that we are not going to be surprised on any of these kinds of activities, whether they're problems with FHA, or problems that may be building up in the banking system.

As you probably know, we've already had seven hearings this year on the banking system, changes that may be needed there, looking at the deposit insurance system to make sure that we don't have another S&L situation developing in any manner or form over there.

The same thing with respect to housing programs, of which this one, of course, is a very important one, very important in terms of its public purpose, but also in terms of the financial risks that may be building up if we're not careful with what's being done here.

So I want to make it very clear that the full committee will be prepared to consider promptly and fully any recommendations developed by this subcommittee. As you plow through this report from Price Waterhouse and the testimony, if it looks as if reforms are needed, I don't want us to hesitate. I want us to figure out, starting with the subcommittee, but then the full committee, what ought to be done and get at any corrections or strengthening steps that have to be taken.

That's an obligation that I think we have, and that's not just to catch problems after the fact, but to get ahead of these things. And I'm determined to see us do that at the full committee level.

Thank you, Senator Cranston.

Senator CRANSTON. Thank you, Mr. Chairman, for those very helpful comments. Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Mr. Chairman, I'm here before the subcommittee today because, like many of my colleagues on the Banking Committee, I'm deeply concerned about the fiscal health of FHA.

We've been waiting for many months for the results of the GAO and HUD Price Waterhouse reports on FHA. I'm glad that representatives of each of those organizations are here before us today, and I hope the witnesses will be able to answer fully the questions put to them by the subcommittee today. And I also hope that they don't sugar-coat what they have to report.

If it's a bitter pill, let's take it, and spend the rest of our energy finding solutions to whatever problems are before us. Let's not in any way ignore the facts or attempt to sweep anything under the rug.

The reason I say that and want that understood very clearly, that in 1986, I suppose I felt like the little Dutch boy with his finger in the hole in the dike when I fought for \$15 billion of FSLIC recap and passed it in the Senate, with Chairman Riegle's help, and we were ignored by the House of Representatives, and that was to pump into the S&L crisis some badly needed funds at that time.

It's amazing to me now that some of the same people who say that the cost of that problem may be into the hundreds of billions of dollars are the same people who argued back in 1986 and voted for a \$5 billion FSLIC recap and said that that was sufficient because the problem was no bigger than that.

Well, I would suggest that this is one that we ought to be on top of and not make any mistakes, and that's why I say nothing should be sugar-coated and nothing should be overlooked.

While many may not give the average American credit for even being aware of FHA, a number of publications in the last week—Barron's, U.S.A. Today, U.S. News & World Report, the Washington Post, Newsweek, and others—have all mentioned the problems and potential disaster which may be present in the FHA fund.

While we've been hearing a great deal lately about the GSE's and their implicit Government guarantees, let me remind everyone that FHA has an explicit guarantee by the Federal Government. Any losses incurred by FHA must be covered by the Federal Government. That means the taxpayers. Let's make certain now that FHA is healthy. Put any necessary measures in place that will ensure the health and stability of FHA.

I suggest that it's time that we all work together and find solutions to any problems that exist under FHA and do it as quickly as possible.

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you very much. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I appreciate the opportunity to participate in this hearing.

My interest in this hearing has been picqued by my service with Senator Mack and other committee members on the select subcommittee looking at the Moderate Rehabilitation Program within the

Department of Housing and Urban Development. The subcommittee work has brought us into contact with the FHA several times.

Therefore, I am particularly interested in what the Secretary and others will have to say about the state of the FHA program.

One of the things that we learned in our hearings on HUD, Mr. Chairman, was the failure over a period of time to go back to basics and to reexamine purposes. What were particular programs intended to accomplish and were those goals still relevant?

It has been said that one of the things that most philosophers will agree upon is that the fundamental human stupidity is forgetting what it is that you're trying to accomplish.

I believe that we have been guilty of that fundamental stupidity several times in various HUD programs, and so I will be interested today in probing questions such as what is the Federal Government's role in mortgage insurance? How does that historic role relate to the current economic circumstances of American housing? And how well is that goal being accomplished under the current program, and under the suggested reforms?

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you very much. Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator PRESSLER. Thank you, Mr. Chairman.

As I understand it, we are at a crossroads here. Mr. Ols, of the General Accounting Office, who is to appear on the next panel, states the options. If we decide the Mutual Mortgage Insurance Fund is not actuarially sound, then his recommendation is that Congress should not raise the mortgage ceiling to the 95-percent level because this action may subject the Federal Government to enormous costs over the life of the new insurance that will be created.

On the other hand, if we conclude the Fund is actuarially sound, it is his contention that Congress should consider raising the mortgage ceiling to 95 percent of a State's median house price because doing so will have a positive effect on the Fund's cash position and will allow homebuyers in high priced States to participate more actively in the FHA program.

In other words, I think the decision we need to make here is much like at the beginning of the S&L crisis. We have a choice to make—to bite the bullet—to address the problem now or to hope that during the 1990's, the fund is going to be actuarially sound. Unless other steps are taken, the only way it can be sound is if there is a sustained increase in prices of homes and a growing economy.

So I lean at this point to concluding that the fund is not actuarially sound, to put it mildly, and I think we should take that course.

But I look forward to hearing the witnesses.

Senator CRANSTON. Senator Mack.

Senator MACK. No statement.

Senator CRANSTON. We've completed our opening statements. It's now your turn, Jack.

STATEMENT OF JACK KEMP, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC, ACCOMPANIED BY JOHN WEICHER, ASSISTANT SECRETARY FOR POLICY DEVELOPMENT AND RESEARCH, AND MARY BURNETTE

Secretary KEMP. Mr. Chairman, I would like to address this panel by walking over to the chart for a moment.

The point that Senator Pressler of South Dakota made, Mr. Chairman, is an accurate one, given the study of FHA and its actuarial soundness by Price Waterhouse, which we initiated, which we had paid for, which we requested, which we have shepherded, and today, are presenting to the U.S. Congress. It shows that FHA is not now actuarially sound.

But we share the premise, Mr. Chairman, that you and Chairman Riegle and Senator D'Amato, and Jake Garn and you, Larry, and you, Bob, and I know you, too, Connie, all agree upon—FHA is fundamental to making the American dream a reality in the lives of the families of low- and moderate-income Americans, particularly for the first time homebuyer.

It's for that reason that we did the study. And it's for that reason that I brought the study up here today and laid it on the table. And it's for that reason that GAO, Price Waterhouse, Mr. Weicher, assistant secretary for PD&R, Austin Fitts, Al DelliBovi, and all the members of my team that are here today. We want to show that, had we continued in the 1990's the way the system was going in the 1980s, by the end of this decade, the type of apocalyptic prediction all too often made too early in the process and scaring everybody half to death would be realized.

The good news is that we can take steps to reverse the decline of the trust fund, put FHA on an actuarially sound basis, and preserve it, Mr. Chairman, for those first time homebuyers. You and I and the rest of this committee believe this is instrumental to recapturing the American dream for those low- and moderate- and middle-income people.

I submit to you, as I will in my testimony, that if we take steps, which are not handed to you in concrete, but are handed to you with good-faith effort, notwithstanding, Mr. Chairman, that unfortunate situation you alluded to earlier, we believe we can build up the trust fund to, by 1993 or 1994, to 1¼ percent of the total insurance and 2 percent by the end of the decade. That would reverse that process and show a sound capital basis, protecting the opportunities for first time homebuyers, and save this very important linchpin of homeownership for those young people, particularly first time homebuyers, that your bill, the Cranston-D'Amato bill, the Gonzalez effort in the House, President Bush's HOPE package, are all designed to enhance. And that's why I'm here.

So this is not the end of the negotiation, Mr. Chairman; it is but the beginning, or we're in the process of it. We have absolutely no desire to hold anything back. I would have liked this to come out last year, not this year. But I think it is propitious, Mr. Chairman, that it comes at a time in which you and Senator Riegle and the Senators on our side of the aisle, Democrat and Republican, want to come together and make sure that there is housing legislation

this year that all of us can take pride in and will get busy, not being a Republican bill or a Democratic bill, but a bill that pursues those great objectives of recapturing the American dream for people who have been left out.

So I want to express my appreciation to you for your patience, your forbearance, and that of Senator Garn and Senator D'Amato, and the members of your own party, Mr. Chairman.

It's clear, thanks to the Price Waterhouse study. They should get a lot of credit for thoughtfully and very constructively dissecting both the problems and the opportunities. And I've made it no secret that I've come to this job with a sense that problems should be viewed as opportunities, albeit, sometimes disguised as insurmountable barriers. But this is an opportunity for us to save a very important part of what you and I both agree is the American dream.

We believe that with prompt action, we can restore FHA to actuarial soundness.

The situation is manageable, if Congress will continue to work with us. And I pledge to you, Chairman Cranston, that we will work with you, notwithstanding some of the problems we've had, to adopt changes that we are recommending. These changes, we believe, will have the necessary effect of replenishing the fund's reserve on a continuing basis, while still achieving the basic goal of providing that homeownership opportunity to a low- and moderate-income, first time homebuyer.

We did, as I said, and you have required of us, to get all of the facts on the table. We asked an independent accounting firm to do a full analysis of our insurance funds. And after a competitive selection process, we retained the services of a very able national accounting firm, Price Waterhouse.

They reviewed the status of the MMI fund, tested it for structural weaknesses, evaluated the impact on the fund of a variety of different scenarios—and let me add parenthetically, Mr. Chairman, we put them through hoops to dissect systemically all of the hypothetical situations that might arise both in the economy, as well as the policy changes that we asked them to give us the results of taking that policy road based upon those hypothetical questions.

They are here to testify after I finish. But let me discuss with you today both what I believe are the findings of the study and the Bush administration's proposal to respond to this great challenge.

First, it's solvent.

The MMI fund is solvent. It has a net worth of \$2.6 billion as of the end of fiscal 1989. That's about a little over 1 percent of the fund's total insurance exposure. Price Waterhouse tells us that the net worth of MMI has been steadily eroding, as the chart points out. In 1979-1980, it had almost \$8 billion.

Each year's new business, throughout the 1980's, there was an average loss of \$200 million. And after distributive shares were paid, it went up to \$350 million per year. This is based on a consensus, however, of private economic forecasts of housing markets for the next decade.

Eventually, therefore, FHA, as we pointed out in our chart, and as Price Waterhouse will testify to, it would have a negative net worth, unless something is done, and I believe right now.

This is the clearest possible evidence of the urgent need to reform FHA and manage it as properly and prudently as the American taxpayer would expect, as well as the Bush administration requires.

Price Waterhouse listed, incidentally, poor management and lax monitoring as two of the major causes of the losses during the 1980's, notwithstanding some of the pressures on the housing markets and real estate markets in various parts of the country throughout the 1980's.

You can be assured, Mr. Chairman, that this administration, and I mean by that, President Bush as President, to Jack Kemp as steward of HUD, will not tolerate any abuse, any mismanagement parallel to, or even approaching, that of the last decade.

However, management reforms alone are not enough, in my view, or in Price Waterhouse's view, simply to restore FHA to financial soundness.

Critical program and policy decisions must be made. And I want you to know, Mr. Chairman, I won't rest at HUD until FHA is made sound, solid, responsible, prudent, and able to serve the American people for the 1990's, as you alluded to in your opening comments.

I want it said right now that I bought my first home, my wife and I bought my first home when I was a young quarterback in the National Football League making about \$6,000. We got our dream house, \$15,000, \$500 down, FHA, 30-year fixed mortgage at 5 percent while the dollar was as good as—

We want to, Mr. Chairman—

[Laughter.]

Secretary KEMP [continuing]. To neglect the lessons of history is to make mistakes in the future.

Here's what we want to do, Mr. Chairman, with your help. I say this to Republican and Democrat alike.

We want to establish minimum capital standards for the MMI fund. We believe the fund should have an amount of capital equal to a minimum of 1.25 percent of total insurance exposure in the immediate future, with a goal of 2.0 percent, to be achieved during the 1990's.

Part of the reason that we're tardy with our ability to present this was that, between OMB and HUD, the administration and our friends in the Congress, there has been a debate over what is actuarial soundness, because the legislation does not specifically identify what are the criteria surrounding the words, actuarial soundness.

So we have had to go through the exercise not only of trying to pursue the goal of actuarial soundness, but to identify it, set up the criteria, and to make sure that we are following sound and prudent business practices with an eye on the social, as well as the public, goal of affordable first time homeownership opportunities.

We want a premium structure which is sufficient to cover expected and normal operating losses. We're proposing today, Mr. Chairman, a five-part strategy to achieve these objectives in the 1990's.

We want FHA in the 1990's not only to be sound, but to pursue the following objectives.

No. 1, a risk-related premium structure with a slightly higher premium for loans with lower down payments. The current, up-front premium, as you know, Mr. Chairman, is 3.8 percent. That would go unchanged. But we want to add a premium, or to the premium, 0.5 percent per annum on the higher risk loans.

The terms of this premium would vary, depending, of course, on the down payment.

No. 2, end the practice of financing most closing costs in the mortgage. Homebuyers would have to pay two-thirds of the closing costs in cash when they buy the house or home.

With this change, every homebuyer would have at least 2-percent real equity in their home, which we believe will reduce defaults.

And No. 3, discontinue paying distributive shares in the future, but to pay them on the past business into which we entered that was predicated upon, we believe, a fiduciary responsibility to fulfill our commitment to those who had expected a distributive share.

No. 4, hold mortgage limits at present level. Notwithstanding the debate over this, Price Waterhouse, in my view, tells us that raising the limit will not improve the overall actuarial position of the fund; moreover, we don't believe, Mr. Chairman, that the Federal Government should be providing mortgage insurance for high-income homebuyers. Its historic and proper mission is to serve the low and moderate and, as you pointed out, first time income homebuyers.

No. 5, make further administrative reforms throughout FHA, particularly in the area of property disposition.

This was alluded to by Senator D'Amato and has been the subject of previous hearings and problems. We also intend to reform our accounting system to prevent fraud in the future, improve our underwriting practices, and monitor lenders more carefully.

And I can report to you that we're doing that as of this moment. But that with Price Waterhouse's help, we think we're going to get a far better outcome throughout the whole accounting system of FHA, which was sadly neglected in previous years.

We have started by establishing an absolute minimum definition of actuarial soundness, as I pointed out. I suggested that section 203 of the National Housing Act requires that the Secretary of HUD administer the MMI fund in a manner consistent with sound actuarial and accounting practice.

The statute itself, as I said, provides no further definition. We believe that sound financial practice should be defined as administering the MMI fund in such a way that an ordinary economic fluctuation will not deplete the fund's reserves and capital in the future, as it did in the decade of the 1980's.

Certainly, any risk that FHA might become a burden on the taxpayer has to be unacceptable a priori.

But while the current financial health of the MMI fund is not in immediate jeopardy, as some have feared and reported, the trends are in the wrong direction, and we in the Bush administration do not believe that the current situation is consistent with either the common sense or the statutory standard of financial soundness.

So I do ask that FHA raise its capital to not only 1.25 percent as soon as possible, but move to 2.0 percent as a minimum goal that should be achieved by 1998 or 1999, at the latest.

I want to stress that these are minimum requirements. Private mortgage insurers typically must maintain minimum capital of 4 percent of insurance in force. FHA insurance does differ, as you pointed out, Mr. Chairman, from the private mortgage insurance in several ways, and that different capital standards are deemed appropriate.

Yet even the 1.25-percent standard cannot be met unless we change the current structure of FHA.

As we became aware of the scope of the problem, we asked Price Waterhouse to evaluate, as I pointed out earlier, many possible alternatives and hypothetical situations that would make the MMI fund sound and solvent once again. They're described in the Price Waterhouse report.

We considered, for instance, the possibility of increasing the premium. If we did that, the premium would have to be 6 percent. We considered the possibility of raising the minimum down payment, leaving the premium unchanged. And if we did that, we would require a down payment of almost 11 percent. And that would delay, as you pointed out, Mr. Chairman, and other members of my party, the home ownership opportunities for so many low- and moderate-income, first time homebuyers in America.

We rejected extreme options in favor of the five-part strategy. This is not the end of a debate, as I pointed out; it is but the beginning. But we look forward to doing anything we can to both change the structure of FHA, as well as improve the administration.

First, as I pointed out, is the risk-related premium. The PW study confirms what other studies have shown in the past. FHA takes greater risks, incurs greater losses on the mortgages with the lowest down payments. The default rates are almost twice as high on mortgages with less than 5 percent down payment as they are on mortgages with 10 percent down payment or more.

The monthly payment, incidentally, would rise by as little as 4 percent for a high-risk homebuyer. This is, I believe, a small change to achieve a very major reform in FHA.

Second, unlike private mortgage insurers, FHA allows homebuyers to include closing costs in the mortgage and pay them on a monthly basis as part of their mortgage payment. This raises the amount that they owe on the mortgage, raises their monthly payment, increases the risk of loss to the MMI.

If homebuyers were to pay two-thirds of their closing costs when they buy, that would reduce the number of especially risky loans now insured by HUD.

Every FHA buyer would, in effect, be required to have at least, Mr. Chairman, 2 percent equity in their home at the time they buy it.

Incidentally, people who would buy a home worth more than \$50,000 would have to have at least 3 percent equity.

Third, in the past, FHA paid its distributive share. I mentioned this in the 5-point strategy. But we have been paying mortgagors who paid off their mortgage in full at the end of the 30-year term, or who prepaid. These distributive shares represent the excess of

the premium payment over the loss for the group of homeowners that took out their mortgage in any particular year.

At present, there's no excess of premium over the loss and there's not been for any year's business since 1979. So we are proposing to operate FHA on an actuarially sound basis, paying our claims, building our capital to 2 percent, and we do not propose to set FHA premiums so high that FHA will be in a position to pay the distributive shares on mortgages that it insures in the future.

We will propose, or are proposing, Mr. Chairman, to continue paying the distributive share on the mortgages written before 1980, as those mortgages reach full term or are prepaid.

Fourth, Mr. Chairman, we don't believe that FHA mortgage limits should be raised. The Price Waterhouse analysis concludes that, contrary to popular impression, raising the loan limits will not help MMI. The actuarial position of the fund is not materially affected. Higher value loans are just as likely to default as lower valued ones, if they have the same downpayment and loan-to-value ratio.

This applies to loans up to the conforming limits as well.

FHA insurance is intended, as you pointed out, to serve a social and public purpose of helping those first-time homebuyers who are low- and moderate-income levels.

To achieve that purpose, it's our belief that FHA and the Federal Government provide an implicit subsidy through the mortgage insurance program and our proposals will allow FHA to continue to achieve the same social and public good, but at the same time, the resources of FHA should not be committed to allowing relatively higher income borrowers to buy homes at very low downpayments.

Federal credit, in my view, should not be used to allow someone with an income of \$75,000, for instance, to buy a house worth \$180,000 or \$190,000, with a 5 percent downpayment. That is a use of a Federal resource that I don't believe can be justified.

But for the same reason, Mr. Chairman, I believe that FHA should not be in the business of insuring second homes or vacation homes. We propose to terminate, and have asked Congress repeatedly to help us terminate that type of insurance.

I must express some disappointment that we were not given the authority to do so, notwithstanding the tremendous cooperation we got from the Congress in reform one, H.R. 1, of 1989.

FHA's job is to help low- and moderate-income families become the first time homebuyers, not first time second homebuyers.

Fifth, FHA will undertake substantial and significant administrative reforms. We've already begun, but these improvements will cover a far broader spectrum of FHA's operations.

Lender reforms. The S&L situation alluded to by Senator D'Amato, Senator Cranston, Senator Riegle, and Senator Garn, has taught us the shortsightedness of abdicating the regulatory authority over firms that can commit the resources of the Federal Government and expose the taxpayer to a loss.

FHA will increase its monitoring and the enforcement efforts. Until now, we have only disciplined lenders when we had reason to believe that fraud had occurred. We will extend our enforcement efforts to lenders who engage in any careless practice of underwriting.

The best way to achieve actuarial soundness is to decrease the claims. We will be tightening our underwriting standards on the basis of risk characteristics.

And moving on to property disposition, each year, FHA pays \$500 million in carrying costs on the 80,000 or so homes that it has foreclosed on and is in the process of selling. Foreclosed and boarded-up homes do not improve with age. And they certainly don't improve property values in the neighborhood or the community.

We are developing and will be announcing very soon a set of administrative reforms designed to return these homes to use more quickly at less cost to FHA and the Federal Government.

FHA can achieve substantial savings, Mr. Chairman, if it can cut its losses on the foreclosures. The PW study assumes that losses will average 37 cents on the dollar, which is basically the average loss on each foreclosure during the 1980's.

For every cent that FHA can reduce that loss—selling houses sooner before they depreciate, for example—FHA's net worth will rise by \$150 million, according to that analysis so ably carried out by Price Waterhouse.

These savings will help us achieve, Mr. Chairman, that long-term goal that we both share of improving FHA's capital position during the 1990's.

I want to stress, Mr. Chairman, that we're not counting on any savings from these so-called administrative reforms. I don't say so-called to make light of them. They're extremely important.

Accounting standards do not allow proposed management improvements to count as equity for purposes of the capital requirement. And that is, we think, correct and proper practice.

But the FHA reforms that I've described this morning—raising the premium on risky loans, requiring buyers to have at least 2-percent equity in their home, ending the practice of paying distributive shares for future business, retaining mortgage limits at their present levels—are designed to achieve the absolute minimum that is necessary for FHA to be considered actuarially sound by themselves without administrative reforms.

But, in addition, we intend to continue reforming FHA so that we can say to the American homebuyer, the American taxpayer, and to those who hope to be homebuyers in the 1990's, this exciting decade ahead, that FHA is going to be operating on a prudent and sound, responsible, and a business-like basis, as efficiently and economically as it possibly can for this extremely important social and publicly desirable goal.

I'll conclude at that point, Mr. Chairman, and say that Mr. DelliBovi, my undersecretary, is behind me. Austin Fitts, the commissioner of housing, is also behind me. And I'm at the table with my assistant, Mary Brunette and also my assistant secretary of housing for policy development and research, John Weicher, who is a long-time housing economist, was at AEI for many years, and has served in the Government and I'm proud that he has come back. He has been helping me, along with Austin Fitts and Al DelliBovi, to get FHA ready for the 1990's. And we appreciate the chance to testify.

[The complete statement of Secretary Kemp follows:]

STATEMENT OF SECRETARY JACK KEMP
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

JUNE 6, 1990

Chairman Cranston and members of the Subcommittee, thank you for this opportunity to address the financial status of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund (MMI), and the steps the Department has taken and is proposing to take in the future to ensure that the FHA continues to meet its historic mission to provide affordable homeownership opportunities for low- and moderate-income American families.

I appreciate the patience of the Committee -- and the American people -- in awaiting the report on the health and status of FHA. It was an enormous undertaking to assess the actuarial soundness of the Mutual Mortgage Insurance Fund, but through the outstanding efforts of the accounting firm of Price Waterhouse, the Department is fully apprised of the Fund's true condition and is now able to propose a set of changes that will strengthen FHA and make it better able to serve first-time homebuyers in the 1990s.

Mr. Chairman, it is clear to us that FHA faces financial problems, unless we make changes. The fund has not been operated on a sound basis. We believe that FHA must be promptly restored to actuarial soundness. However, the situation is manageable, if

Congress adopts the changes we are recommending. These changes will have the necessary effect of replenishing the Fund's reserve on a continuing basis, while still achieving the basic goal of providing homeownership opportunities for low- and moderate-income first-time homebuyers.

When we began our comprehensive review of FHA early last year, it became unambiguously clear that, because of past mismanagement and neglect, FHA was ill-equipped to serve as a primary tool for homeownership opportunity in the 1990s. We had no real picture of the financial status of FHA's programs, nor was there a mechanism in place to enable us to determine, on a timely basis, the actual financial status of the funds.

We needed the facts. We decided to ask an independent accounting firm to do a full analysis of the insurance funds. After a competitive selection process, we retained the services of Price Waterhouse, which has reviewed the status of the MMI fund, tested it for structural weaknesses, and evaluated the impact on the fund of a variety of different scenarios. The Price Waterhouse study has now been completed, and I am pleased to be able to present it to you, Mr. Chairman, and to the other members of this Committee, to Congress, and the American people, this morning.

I want to discuss with you today, both the findings of the study and the Bush Administration's proposals in response to it.

First, the MMI fund is solvent; it has a net worth of \$2.6 billion, as of the end of fiscal year 1989. This is just over 1

percent of the fund's total insurance exposure. But Price Waterhouse also tells us that the net worth of the MMI fund has been steadily eroding in the last decade -- back in 1979, it had a net worth of \$8.0 billion. Moreover, each year's new business will lose money for FHA, at the rate of \$200 million (or a total of \$350 million after distributive shares are paid on old business). This is based on a consensus of private economic forecasts of housing markets for the next decade.

Eventually, therefore, FHA will have a negative net worth, unless something is done. This is the clearest possible evidence of the urgent need to reform FHA and manage it properly. Price Waterhouse lists poor management and lax monitoring as two of the major causes of the losses during the 1980s.

You can be assured, Mr. Chairman, that the Bush Administration will never tolerate the abuses and mismanagement that happened in the past. However, management reforms alone will not be enough to restore FHA to financial soundness. Critical program changes are also essential. We will not rest until FHA is made sound and solid and able to serve the American public for the 1990s.

Here is what we propose to do, Mr. Chairman.

We want to establish minimum capital standards for the MMI fund. We believe the fund should have an amount of capital equal to a minimum of 1.25 percent of total insurance exposure in the

immediate future, with a goal of two percent to be achieved during the 1990s.

We also want a premium structure which is sufficient to cover expected and normal operating losses.

We propose a five-part strategy to achieve these objectives:

- (1) A risk-related premium structure, with higher premiums for loans with lower down payments. The current upfront premium of 3.8 percent would be unchanged. But we want to add a premium of 0.5 percent per year, on the high-risk loans. The term of this premium would vary, depending on the down payment.
- (2) End the practice of financing most closing costs in the mortgage. Homebuyers would have to pay two-thirds of the closing costs, in cash, when they buy the house. With this change, every homebuyer would have at least two percent real equity in their home, which will reduce defaults.
- (3) Discontinue paying distributive shares for future business, but continue to pay them on past business, for years when premiums exceed losses.
- (4) Hold the mortgage limits at present levels. Price Waterhouse tells us that raising the limits will not improve the actuarial position of the fund. Moreover, we do not believe that the federal government should be providing mortgage insurance for high-income

homebuyers. Its historic and proper mission is to serve low- and moderate-income homebuyers.

- (5) Make further administrative reforms throughout FHA, particularly in the area of property disposition. We also intend to reform our accounting systems to prevent fraud in future, improve our underwriting practices and monitor lenders more carefully.

Mr. Chairman, let me explain this set of proposals in more detail. We have started by establishing an absolute minimum definition of "actuarial soundness." Section 203 of the National Housing Act requires that the Secretary of HUD administer the Mutual Mortgage Insurance Fund "in a manner consistent with sound actuarial and accounting practice." But the statute itself provides no further definition. This Administration believes that sound financial practice should be defined as administering the MMI fund in such a way that ordinary economic fluctuations will not deplete the fund's reserves and capital. Certainly any risk that FHA might become a burden on the taxpayers is unacceptable. While the current financial health of the MMI fund is not in immediate jeopardy, as some have feared, the trends are all in the wrong direction, and the Bush Administration does not believe that the current situation is consistent with either the commonsense or the statutory standard for financial soundness.

In order to provide adequate protection, I believe that FHA should raise its capital to 1.25 percent as soon as possible.

Furthermore, I regard two percent as the minimum goal that should be achieved during the 1990s.

Mr. Chairman, I want to stress that these are minimum requirements. Private mortgage insurers typically must maintain minimum capital of four percent of insurance in force. FHA insurance differs from private mortgage insurance in several ways, and different capital standards are appropriate. Yet even the 1.25 percent standard cannot be met over the next few years, unless we change the current structure of the FHA program.

Mr. Chairman, as we became aware of the scope of the problem, we asked Price Waterhouse to evaluate many possible alternatives to make the MMI fund sound and solvent once again. These are described in their report. We considered the possibility of increasing the premium; if we did that, the premium would have to be six percent. We considered the possibility of raising the minimum downpayment, leaving the premium unchanged; if we did that, we would require a downpayment of eleven percent, and we would delay homeownership for many low- and moderate-income first-time homebuyers.

We have rejected these extreme options, in favor of the five-part strategy that I outlined above. We will change the structure of the FHA program, and improve the administration in a number of ways.

First and most important is the risk-related premium. The Price Waterhouse study confirms what other studies have shown in the past: FHA takes greater risks, and incurs greater losses, on the mortgages with the lowest downpayments. Default rates are almost twice as high on mortgages with less than 5 percent down payments, as they are on mortgages with 10 percent down payments or more.

FHA can operate a sound mortgage insurance program and serve its basic purpose of helping the first-time homebuyer, but it should receive premiums that are more proportionate to the risk it takes. We can do this, without imposing undue burdens on homebuyers, by adding a premium of 0.5 percent per year -- 50 basis points -- on the high-risk loans. This additional premium would vary, depending on the down payment:

For loans with less than 5 percent down, the premium would be paid for 15 years.

For loans with 5 to 7 percent down, the premium would be paid for 10 years.

For loans with 7 to 10 percent down, the premium would be paid for 4 years.

For loans with more than 10 percent down, there would be no additional premium.

Monthly payments will rise by about 4 percent for the high-risk homebuyers. This is a small change, to achieve a major reform in FHA.

Second: Unlike private mortgage insurers, FHA allows homebuyers to include their closing costs in the mortgage and pay them on a monthly basis as part of their mortgage payment. This raises the amount that they owe on the mortgage, raises their monthly payment, and increases the risk of loss to the MMI fund. If homebuyers pay two-thirds of their closing costs when they buy their home, that will reduce the number of especially risky loans now insured by HUD. Every FHA buyer would in effect be required to have at least two percent equity in their home, at the time they buy it. People who buy homes worth more than \$50,000 would have to have at least three percent equity.

Third: In the past, FHA has paid "distributive shares" to mortgagors who paid off their mortgages in full at the end of the 30-year term, or who prepaid. These distributive shares represent the excess of premium payments over losses, for the group of homeowners who took out their mortgages in any particular year. At present there is no excess of premiums over losses, and there has not been for any year's business since 1979. We are proposing to operate FHA on an actuarially sound basis, paying our claims and building our capital to two percent. We do not propose to set FHA premiums so high that FHA will be in a position to pay distributive shares on mortgages that it insures in the future. We do, however, propose to continue paying distributive shares on mortgages written before 1980, as

those mortgages reach their full term, or are prepaid, because FHA will "make money" on mortgages insured in the 1960s and 1970s.

Distributive shares on pre-1980 mortgages will amount to about \$150 million each year. Paying them will reduce FHA's net worth by \$1.3 billion. However, our proposal to establish risk-related premiums on future business is designed to bring in the \$150 million needed each year to pay those distributive shares, as well as to cover future losses and maintain and increase FHA's capital.

Fourth: We do not believe that the FHA mortgage limits should be raised. The Price Waterhouse analysis concludes that, contrary to popular impression, raising the loan limits will not help the MMI fund. The actuarial position of the fund will not be materially affected. Higher value loans are just as likely to default as lower valued ones, if they have the same down payment and loan-to-value ratio. This applies to loans up to the conforming limit.

FHA insurance is intended to serve a social purpose of helping low- and moderate-income families become homeowners. To achieve that purpose, FHA and the federal government provide an implicit subsidy through the mortgage insurance program. Our proposals will allow FHA to continue to achieve that same social purpose. At the same time, the resources of FHA should not be committed to allowing relatively high-income borrowers to buy

homes with very low down payments. Federal credit should not be used to allow someone with an income of \$75,000 to buy a house worth \$185,000, with a five percent down payment. That is a use of federal resources that cannot be justified.

For the same reason, Mr. Chairman, I believe that FHA should not be in the business of insuring second homes. We proposed to terminate this type of insurance, and I was disappointed that we were not given the authority to do so. FHA's job is to help low- and moderate-income families become first-time homeowners, not first-time second-home buyers.

Fifth: FHA will undertake substantial and significant administrative reforms to minimize future losses and claims on the fund. These improvements will cover the full spectrum of FHA's operations:

Lender reforms. The S&L situation has taught us the short-sightedness of abdicating regulatory authority over firms that can commit the resources of the federal government and expose it to loss. FHA will increase its monitoring and enforcement efforts. Until now, we have only disciplined lenders when we had reason to believe that fraud had occurred; we will extend our enforcement efforts to lenders who engage in careless underwriting.

Underwriting reforms. The best way to achieve actuarial soundness is to decrease claims. We will be tightening our underwriting standards on the basis of risk characteristics.

Property Disposition. Each year, FHA pays \$500 million in carrying costs on the 80,000 homes that it has foreclosed on, and is in the process of selling. Foreclosed and boarded up homes do not improve with age, Mr. Chairman. We are developing, and will soon announce a set of administrative reforms designed to return these homes to use more quickly, at less cost to FHA and the federal government. FHA can achieve substantial savings if it can cut its losses on foreclosures. The Price Waterhouse study assumes that losses will average 37 cents on the dollar, which is basically the average loss on each foreclosure during the 1980s. For every cent that FHA can reduce that loss -- selling houses sooner, before they depreciate, for example -- FHA's net worth will rise by \$150 million, according to the Price Waterhouse analysis. These savings will help us achieve our long-term goal of improving FHA's capital position during the 1990s.

Mr. Chairman, I want to stress that we are not counting any savings from these administrative reforms as part of our plan to restore FHA to actuarial soundness. Accounting standards do not allow proposed management improvements to count as equity. That is the correct and proper practice. The FHA reforms that I have described this morning -- raising the premium on risky loans, requiring buyers to have at least two percent real equity in their homes, ending the practice of paying distributive shares

for future business, retaining the mortgage limits at their present levels -- are designed to achieve the absolute minimum that is necessary for FHA to be considered actuarially sound -- by themselves, without administrative reforms. But in addition, we intend to continue reforming FHA so that we can say to the American homebuyer and the American taxpayer that FHA is operating on a sound, businesslike basis, as efficiently and economically as it possibly can.

Mr. Chairman, these proposals that I am making today are just the latest -- and not the last -- reforms that we believe are necessary in FHA. You will remember that last August I announced to this committee an initiative to reinvigorate FHA and strengthen its finances, entitled "FHA for the 90s." That report stated my goal to address the structural problems in the FHA program by making accounting improvements, improving management accountability, ensuring appropriate monitoring of lenders, and commissioning an independent actuarial analysis of the financial condition of FHA.

Last October, the Administration submitted and Congress approved the Department of Housing and Urban Development Reform Act of 1989, which furthered the Department's capacity to improve the financial status of FHA. I again want to thank this committee for helping the Administration in this unprecedented effort to implement these much-needed reforms.

Mr. Chairman, our reform efforts are well underway. We now require annual, accrual based financial statements, which make it

possible for us to identify both the magnitude and the source of our problems on a timely basis. We have hired a Comptroller for FHA who is an experienced Certified Public Accountant, and we are in the process of hiring a Chief Financial Officer with responsibility for overseeing the financial management and accounting functions for the Department.

The HUD Reform Act eliminated avenues for fraud and abuse in FHA programs by ending investor loans, tightening the rules governing the free assumability of FHA mortgages, and imposing more rigorous standards for appraisers.

Finally, Mr. Chairman, I want to remind you that the MMI fund is only part of FHA -- certainly the largest part and the part that most people think of as being FHA -- but still only part. As we complete the actuarial study of the MMI fund and propose these reforms to you, we are simultaneously beginning a second study, on the financial soundness of the General Insurance Fund, which provides mortgage insurance for a wide variety of purposes, including condominiums, multifamily housing, manufactured housing, and hospitals. We expect the results of that study in nine months and we will have policy recommendations for you at that time.

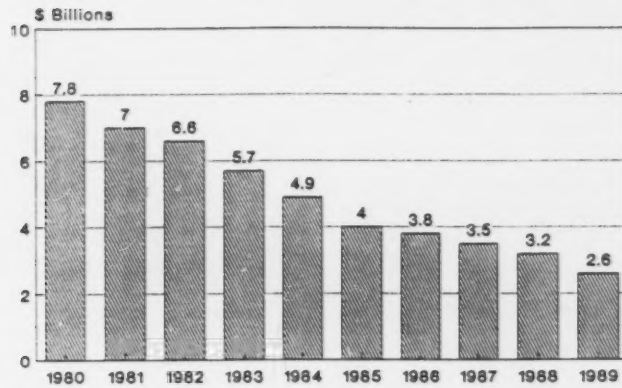
Mr. Chairman and members of this Committee, the future of FHA turns on whether or not it stands on a foundation of financial soundness and managerial integrity. As I have told this Committee on previous occasions, I consider FHA to be one of

the government's great success stories. Just as it was for a young professional football quarterback and his family 30 years ago, FHA insurance is still a key to realizing the American dream of homeownership. Today, more than 6.5 million homes are insured through the MMI fund of the FHA, and the current value of FHA-insured mortgages exceeds \$250 billion. There are 690,000 families who used FHA insurance to buy a home last year; 450,000 of them were first-time homebuyers. Most of these first-time homebuyers made low down payments (less than 10 percent). There will be some defaults and those defaults will impose costs on the FHA fund. But the vast majority of these families will become homeowners -- and stay homeowners -- thanks to FHA insurance.

The Bush Administration is committed to making homeownership possible for these families. I know that you and all my former colleagues in Congress share that objective. We can do it, if we restore FHA to actuarial soundness and financial strength. A healthy FHA will provide long-term support for homebuyers and housing markets across the United States. The reforms that I have described to you, Mr. Chairman, and to this Committee, will do the job.

FHA -- Effect of the 1980s

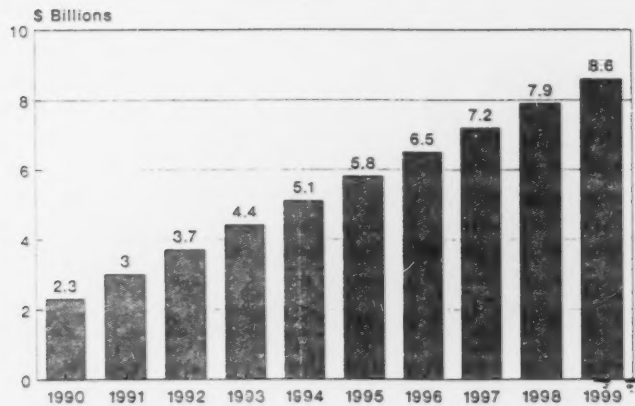
1989 Economic Value*



* That is, what the Fund would have been worth in 1989.

FHA -- Reform for the 1990s

Projected Economic Value



1989 Dollars

Senator CRANSTON. Thank you.

Jack, on the matter that we were concerned about in several of our statements, can we have your assurances that, henceforth, we will get material in accordance with the rules and we'll see stuff before it goes to the press?

Secretary KEMP. Well, Mr. Chairman, I will always abide by the rules. You have been very kind and patient with our problems. We have, we think, presented to the Congress, with your help, of course, and many other members, the President's affordable housing and home ownership goals. We have been working with you.

I think it's fair for the record to state that, while you and I talked yesterday, I did allude to a particular snag that we had over at OMB. Dick Darman has been very gracious in making sure that we could get this testimony up here today.

If you wanted to have cancelled it because we couldn't present the testimony 24 hours ahead of time, I'd be glad to come up tomorrow, come up Friday, come up Saturday, come up Sunday.

I've never ever tried to keep anything away from this committee, and I never have in the past and I won't in the future.

There was a delay. It was, I hope, understandable. It should be put in perspective. And it was not meant to break the rules.

Senator CRANSTON. Well, I understand that.

Secretary KEMP. But if you want me to come back tomorrow, I'd be happy to.

Senator CRANSTON. No, we'll proceed now. We've had too many delays already. We will do our best without having an opportunity to be as well prepared as we—

Secretary KEMP. I'll be glad to come back again, Mr. Chairman.

Senator CRANSTON. Fine. That may be necessary. It may not.

Secretary KEMP. All right.

Senator CRANSTON. You propose substantial changes for FHA insurance. Major changes in FHA pricing and product may very well be needed. Your recommended changes may be precisely what should be done to make FHA actuarially sound, or they may do the opposite.

I'd like to explore with you how the administration analyzed the potential impact of those changes on FHA's portfolio of business.

You're, in essence, increasing the price of FHA insurance and reducing somewhat the benefits of FHA insurance to homebuyers. If the market works, and I think it does, increasing prices and reducing benefits can be expected to reduce demand for FHA insurance, particularly among mortgage borrowers who have the greatest access to alternatives.

Or looked at another way, these changes may make it easier for others to cream away the most attractive business from FHA, leaving FHA with riskier loans.

That's a very important matter because if FHA loses revenues and gets stuck with riskier businesses, we could be looking back 5 years from now and finding that these changes had done harm rather than good in the long run.

I understand you're proposing a 50-basis point surcharge annually for some number of years, and you would require borrowers to pay two-thirds of the closing costs in cash. That's essentially an increase in the current 3.8 percent premium which can be financed.

So what I'd like to start by asking is what is the real impact of the proposed surcharge on the premium charged to borrowers; that is, what's the effective premium increase that would result from the stream of surcharges on a present-value basis? And to be precise in my question, what would the new premium equivalent be in percentage terms and in dollars terms for a typical homebuyer?

Secretary KEMP. The new premium that we're suggesting is aimed, Mr. Chairman, at not reducing the numbers of people who qualify, but reducing the serious danger of high-risk loans defaulting, thus exacerbating the problems that are demonstrably self-evident on that chart of what's happened in the 1980's.

We're, in effect, reducing the high-risk end of FHA business in order to make sure that FHA is around in the 1990's. There's no attempt by Jack Kemp or the Bush administration to reduce the number of people who would be eligible. For borrower putting at least 10 percent down, it would remain at 3.8 percent, in direct response to the question about what would be the new premium at a present value basis.

If a downpayment is less than 5 percent, then it would be 6.6 percent. And if a downpayment is less than 7 percent, but greater than 5 percent, the PV would be 6.2 percent.

The important point, Mr. Chairman, is that all of the increase in the premium occurs in very small amounts over time and the maximum premium increase for the riskiest borrowers would be only \$360 a year, or at least in that ballpark.

So we think that this is a prudent step to take now in order to prevent the diminution of this extremely important trust fund.

Senator CRANSTON. How much more would the average homebuyer need in terms of the downpayment?

Secretary KEMP. I'm going to ask John Weicher to answer that question. Price Waterhouse, I'm sure, will be, also.

Mr. WEICHER. Mr. Chairman, the closing costs, we would expect an increase in the amount equal to 2 percent of the price of the home, which, on the typical FHA home, would be about \$1,200.

Senator CRANSTON. What effect do you think raising the cost of the FHA product, the mortgage insurance premium and the downpayment, will have on the demand for FHA insurance? How many people will opt out or go elsewhere?

Secretary KEMP. That's a question that goes to the heart of the actuarial study. I would defer, of course, to the experts, that is, Price Waterhouse.

But John Weicher, do you have any way of quantifying the results of the policy?

Mr. WEICHER. We've estimated, Mr. Chairman, that the effect would be to reduce the number of borrowers by in the range of 2 to 5 percent per year. That's a small number of borrowers. We anticipate \$50 billion worth of insurance per year. We're talking about a reduction in the range of \$1 billion, \$2 billion, \$2½ billion.

Senator CRANSTON. Thank you. FHA has operated as an insurance fund for low-, moderate-, and middle-income families seeking generally to purchase their first home. In order to maintain its self-sufficiency, it has needed less risky borrowers to offset losses from more risky borrowers.

You're proposing that FHA insurance look much more like insurance offered by private mortgage insurers, it seems to me.

What sort of analysis did the administration do on how these changes would affect the portfolio of business? And particularly, what analysis was done on the likelihood that lower risk borrowers would leave FHA and go elsewhere?

Who did that analysis?

Secretary KEMP. Could you repeat the last part of the question about low-risk homebuyers?

Senator CRANSTON. Yes.

Secretary KEMP. I didn't hear that.

Senator CRANSTON. What analysis was done on the likelihood that lower risk borrowers would leave FHA and go elsewhere? And who did that analysis?

Secretary KEMP. John, do you want to answer that question?

Mr. WEICHER. Sure. Mr. Chairman, we do not anticipate that very many low risk borrowers would in fact choose to shift over to private mortgage insurers.

The effect of this is aimed at the high-risk borrowers. Low-risk borrowers who now put down 10 percent or more would really not be affected by this in any way at all. The minor fraction of FHA's business, which is insurable on the general terms of private mortgage insurers, would not be affected.

Secretary KEMP. And the point needs to be made that no private mortgage insurance is made with downpayments below 10 percent that I know of. And I also want for the record to state that the premium is refundable. This is a refundable premium.

Mr. WEICHER. And the premium does not change, Mr. Chairman, for people who are putting 10 percent down, nor, really, would closing costs—would a greater equity be required than they're now putting up.

They are essentially paying their closing costs now.

Senator CRANSTON. What sort of profile is there of the people that you would lose in the \$2 billion worth of lost business?

Mr. WEICHER. I beg your pardon, Mr. Chairman?

Senator CRANSTON. You indicated about a \$2 billion loss of business.

Mr. WEICHER. Right.

Senator CRANSTON. What profile would explain who those people would tend to be?

Mr. WEICHER. They would be the relatively higher risk borrowers. More of them would be first time homebuyers than repeat buyers. They would be spread essentially evenly through the price distribution of FHA buyers, roughly proportionately to the way they are now. Borrowers buying homes worth less than \$50,000 would drop by a couple of percent. Borrowers borrowing at about \$100,000 now would also drop by a couple of percent.

Senator CRANSTON. It wasn't clear to me who did the analysis about the lower risk borrowers. Was that included in the Price Waterhouse work project?

Mr. WEICHER. I don't believe it is, Mr. Chairman, but that is our analysis of the outcome. If Price Waterhouse has addressed that, I'm sure they can discuss that with you.

Senator CRANSTON. One final question at this point. How do you propose to deal with adverse selection by mortgagors who are able to put more down and attain lower cost private insurance?

Mr. WEICHER. I'm sorry. I'm not sure what the adverse selection element is in there, Mr. Chairman?

Senator CRANSTON. Well, some people will be able to go, who have some resources, will be able to go to mortgagors who will be putting a bit more down and obtaining lower cost private insurance than what will be higher cost FHA insurance.

Mr. WEICHER. If you are able to put the amount down that private mortgage insurers typically require, your premium will not be affected by this and your requirement to pay closing costs will not be affected by this, either, really.

The people who are now putting 10 percent down have the minimum equity that we are requiring through the closing costs. They will not be affected by that. Their premium will not change.

There should be no adverse selection at the low-risk end, Mr. Chairman. There really should not.

Secretary KEMP. I want to remind the committee that in the private mortgage business, insurance business, it's my understanding that there is a 5-percent equity requirement. And ours, I think, at the top would be 3 percent. And for most, would be 2 percent.

So, Mr. Chairman, it needs to be said once more that we are not trying to get out of the social and public responsibility of helping finance low- and moderate-income homes for first time homebuyers.

What we're trying to do is to, at the margin, reduce the high risk element that has caused these declines and get steadily back to a higher capital requirement. I think the lessons of the 1980's ought not to be lost on this very important committee.

Senator CRANSTON. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Secretary, on page 4—and maybe I should direct this question to Mr. Ols because it's his testimony—he says that—

Secretary KEMP. Page 4 of what, Al?

Senator D'AMATO. Mr. Ols's testimony of the General Accounting Office, and that of Price Waterhouse, which say that at an annual 2- to 4-percent house price appreciation rate, the fund will be unable to meet a positive cash balance without Treasury assistance if no policy change is made or if any of the proposals we reviewed are adopted, even if economic conditions remain generally favorable.

It just seems to me that that statement squares with the President's budget message, which projects, and I quote, "that the FHA losses may total tens of billions of dollars over the next two decades."

And I say it squares with it because, as you and I both know, we're not seeing any appreciation of the value of homes in most of the markets in this country.

This is a dire prediction. The testimony says that 2- to 4-percent appreciation is going to result in the fund balances going down. And I can point to areas, whether they be in New England or whether they be in Long Island, or whether they be here in this area, where the prices on houses are going down. They're decreasing, in some areas, dramatically.

Now, coupled with the S&L problems, we have additional pressure forcing market conditions to respond. And I don't see how anybody can predict 2 to 4 percent. And, by the way, 2 to 4 percent, is going to result in a loss.

And I think some of the testimony that the Price Waterhouse people give us would indicate that they're looking for a growth of 6 percent or better for the fund balances to be safe.

My staff just gave me the President's budget message. FHA, as now operated, could lose tens of billions of dollars over the next two decades. More than half of this loss would be the result of commitments outstanding at the end of 1990.

Secretary KEMP. That's if nothing is done. That's if nothing is done. I assume that we are smart enough to take steps to change a policy that is leading to that conclusion.

I don't plan to stay at HUD and allow that to happen, and I would assume that you and I and this committee would agree that the President's budget only assumes that no changes are made.

Goodness gracious, we've had predictions of an ice age and a prediction of a global warming. I assume that men and women of civility in a liberal democracy such as ours can come to conclusions that can offset apocalyptic predictions about the future of our country. And I'm here to say that I don't accept an apocalyptic condition for FHA.

But if you tell me that we can't make any changes, then I would get pretty pessimistic.

Senator D'AMATO. Well, I'm not suggesting that. I'm suggesting that we should take a picture as to what it is and what the future, based upon those conditions that we're dealing with, looks like?

And when I see the testimony from the General Accounting Office indicates that—

Secretary KEMP. Well, ask him. Ask him directly, Al. There's going to be a fierce debate over this issue. I would suggest that I am going to stick with my predicate. You'll get a chance to talk to GAO. You'll get a chance to talk to Price Waterhouse. There will be a healthy, open, and free-wheeling debate over the ceiling.

There was in the Senate. You raised it to 124 point, whatever, five. We support that.

I would like to work with you to find some way to index it, perhaps.

Senator D'AMATO. I have to suggest to you that I have no preconceived idea as to what should or shouldn't be done. But I do believe that we've got some very, very serious problems and I think you share that belief.

I am open at this point to doing whatever can and should be done to attempt to stem the losses and to reverse this position because I find it most disquieting. We've got some pretty good staffers here and they indicate—for example, that in the most recent audit of the FHA that Price Waterhouse worked on the audit showed that the MMIF had \$1.8 billion of equity as of September 30, 1988.

That's this GAO report here [indicating], if you look at page 3. Now, the testimony states that the MMIF has \$2.6 billion of equity. How could that be?

Secretary KEMP. Ask Price Waterhouse.

Senator D'AMATO. Well, you've got somebody over here—

Secretary KEMP. Yes, their report is \$2.6 billion. It depends on how you estimate the reserve in FHA. And so these are all predicated upon estimates. And you can ask Price Waterhouse, GAO questions.

Senator D'AMATO. My point is that if we have the Price Waterhouse FHA report, which was submitted to us by the GAO this past February, which indicates that they had \$1.8 billion in equity, then to come forward and to indicate that in the last year and a half, that equity is now \$2.6 billion, I must attempt to find out what the discrepancy is.

Secretary KEMP. Well, I'll let John Weicher answer to give you some perspective on that, Senator D'Amato.

Mr. WEICHER. Senator, it is confusing. The difference is the \$1.8 billion is based on generally accepted accounting practices. It's GAAP accounting. The \$2.6 billion is the market value.

The Price Waterhouse study that has been done for us is in terms of market value, and those are all the numbers that you see on the charts and that are referred to in the testimony. It is confusing. It is not meant to be a difference in reality.

Senator D'AMATO. All right. So, then, we've got to work from a common baseline.

Secretary KEMP. But it's single-entry bookkeeping to only look at one accounting technique.

Senator D'AMATO. Jack, I'm not arguing with you about it.

Secretary KEMP. Right.

Senator D'AMATO. This is just something that comes to the fore. If anything, I think I probably agree with you much more today than any other time in relation to this issue—we've got a very severe problem. And as Jake Garn said, when we were asking for \$15 billion in the beginning dealing with the S&L's, we hit tremendous resistance. And had we come up with the \$15 billion, maybe we could have stemmed some of those losses. We would still have had the crisis, but it may have been ameliorated somewhat.

I am very much concerned with the predictions of the economists. I've just had the first opportunity to look at some of the Price Waterhouse testimony. If you look at the testimony, it says that unless the value of homeownership, singlefamily homes, rises at some rate, 3, 4, 5 percent annually, the fund will be in deep trouble.

Secretary KEMP. Senator, that is true of every single policy issue over which you and are currently conducting debate. That's true of the S&L problem. Secretary Brady sat right here just a couple of weeks ago with me and Alan Greenspan and two other members of the RTC Oversight Board and told you that the cost is inextricably linked to the value of all real estate. And as the value of real estate were to decline, the cost would go up.

There's no doubt in my mind that we have to do something. And if you told me that last year we would not have passed the President's cut in capital gains tax rate, I could have predicted to you that there would be a diminution of value of all capital assets in the United States of America.

So the good news, however, is that if we take steps right now, we can prevent the type of disaster happening to FHA that happened in the S&L crisis, in my view.

That's why I'm HUD Secretary. That's why I want to stay and see this through. But we've got to make changes. But I don't believe in coming up here and telling you that the sky is falling on us, because I believe we're rational men and women and we can take steps to prevent bad results. But we've got to move.

And the sense of urgency I hope is in my voice.

Senator D'AMATO. Well, I've detected the sense of urgency. My time is up, but I'm going to ask you in my second round, what steps that you think, in the analysis concluded, can add to the base and give us some support there because I think it's going to take more than just HUD. It may take capital gains.

Certainly, the real estate market is depreciating. Maybe Senators Graham and Mack of Florida can comment on what they see in the real estate market in their States. I just see it going down. I don't see it going up.

I think that's going to exacerbate this problem. I'm beyond my time, Mr. Chairman, but I'd like to pursue that.

Senator CRANSTON. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Some of these questions are going to be more basic than we would like them to be because of the limited time that we've had to review the material.

But does the Price Waterhouse study indicate the relative impact of factors such as the amount of downpayment, the monthly debt service requirements, the annual income of the owner? Which of those, or other, factors, and in what combination, have had the greatest contribution to the diminution of the fund?

Secretary KEMP. Bob, if you would, let me have John Weicher, my assistant secretary, answer the question because he's been living with this day and night now for the length of the study and is far more familiar with the input and those other factors.

So, John, do you want to shed some perspective on this question?

Mr. WEICHER. I'll try.

Secretary KEMP. No, just do it. Don't try. [Laughter.]

Mr. WEICHER. Senator, there are the problems that the Secretary alluded to, the problems of poor management and lax monitoring, and those have contributed their share.

Economically, in addition, we have had the regional problems in the Southwest. Part of FHA's problem is FHA's share of the Southwest problem, the problems in the oil patch.

In addition to that, underwriting was not as solid as it should have been. The economic downturn in the early 1980's has contributed. We had higher defaults in that period of time. That is now behind us, but it certainly took its toll and you can see that in the chart up there.

It is a combination of the earlier downturn, the regional problem, and the problems within the department and within FHA.

Secretary KEMP. May I just add a footnote? I apologize. But John is typically, as an economist, looks at the trees and I want to look at the forest for a moment.

Plainly speaking, Bob, FHA was mismanaged. It was backing risky loans on the cheap. PW found that FHA was making a high number of investor mortgages, low downpayment loans, without charging adequate premiums.

And as I want to add to John's economist-like presentation, but that's why he's with me—he is a man of dotting "i"s and crossing "t"s. But poor management exacerbated the problems of inflation in the 1970's. It's unacceptable to me and to President Bush, and we think these reforms are desirous, and immediately.

Senator GRAHAM. Before you can be an effective prescriber of remedies, you first have to be a diagnostician and understand what the nature of the malady is. And that's what I'm trying to understand.

Secretary KEMP. Well, I told you.

Senator GRAHAM. But looking at the profile of the FHA-insured borrowers, and then looking at those who subsequently contributed to the problems of the fund by their financial inability to sustain their obligations reveals a question as to which factors have been most contributory. Has it been those persons who had the smallest downpayments, those persons who had the highest monthly debt service in relationship to their annual income, or are there other factors within the analysis of the pool of your insured?

Secretary KEMP. Well, the loan-to-value was over 100 percent. There were low downpayments. There were high-risk underwritings made.

John, do you want to elaborate on the profile of a risky borrower? But all of this was exacerbated by the policies of the late 1970's, and then going from an inflation of the 1970's, where the dollar was falling at a rate of about 13 percent per annum, to a hard money policy, if you will, in the early 1980's, that shifted from inflation to deflation, and lenders were borrowing short and lending long. Lenders were paying back on paper what the value of the property had been reduced.

So they were getting caught betwixt and between that inflation and deflation.

There's never been an experience like this in the 20th century, where we went from such rapid inflation—and I point my fingers down because that means a fall in the value of the dollar, which actually helps in some models borrowers, but at the expense of the lender.

And now—I'm sorry.

Senator GRAHAM. I'm not trying to ask a general economic history question. I'm asking sort of a specific analytical question.

And that is, in analyzing those people who got into trouble, were the principal problems those that had the smallest downpayments, those that had the highest monthly debt service requirement to their income——

Secretary KEMP. And low equity.

Mr. WEICHER. Low equity.

Secretary KEMP. Had low equity in their house. It makes it easier to default.

Senator GRAHAM. Yes, that would particularly focus, I would assume, on the amount of the initial downpayment.

Mr. WEICHER. That's right.

Senator GRAHAM. It appears as if your prescription is primarily focused on the issue of the monthly payment in relation to the ability to pay.

I may be wrong. But is that your diagnosis of where the principal problem has been?

Mr. WEICHER. The principal problem, Senator Graham, is, as the Secretary said, it is people who make a low downpayment to begin with and who have low equity in their home.

Secretary KEMP. And high loan-to-value mortgages.

Mr. WEICHER. That's right. That's right. It is not really people with a particularly high payment-to-income ratio. That is a minor contribution to the factor. It is low downpayment and then if you have very little equity in the home and your particular home does not appreciate very much in value, or depreciates in value, or your region, as in the Southwest, property values drop, then you are in trouble.

Those are the risky borrowers and that is the single dominant factor in determining who will have trouble.

Senator GRAHAM. You stated that you estimate that I think 2 to 5 percent of the current eligible persons for FHA insurance with the changes that you've recommended would not be able to qualify.

Is that correct?

Mr. WEICHER. That's right. They would opt out.

Senator GRAHAM. The statement indicates that last year, there were 690,000 families who received FHA insurance. So that would indicate that roughly somewhere between 14,000 and 35,000 would not be able to qualify with these new standards.

Is that correct?

Mr. WEICHER. That's right.

Secretary KEMP. I was just going to say, we've been getting around 80,000 defaults a year in recent years. And we're trying to reduce that significantly, not take FHA out of the social or public purpose of helping home purchases, but reducing the high loan-to-value, reducing the very low downpayments that were being paid, and limiting the loan-to-value to 100 percent instead of way over 100 percent.

So these things help you get a profile on what we're trying to do. But I didn't want it to escape attention that it must be placed on the regional economic conditions, the deflation, and the mispriced insurance, and the management problems of the past.

Senator GRAHAM. Well, your comment added a second question to the one I was going to ask.

The one I was going to ask was what other policy changes within HUD are being recommended to deal with this group of individuals who currently are able to acquire housing, but will be unable to do so as a result of this change?

The second question is, if we had 80,000 defaults last year and the number of persons that are going to be eliminated from their ability to participate is in the range of 14,000 to 35,000, does that indicate that you assume if the current stream continues, that we will be at a range of 45,000 to 65,000 defaults?

Mr. WEICHER. No.

Secretary KEMP. Go ahead.

Mr. WEICHER. You'll have fewer defaults as well, Mr. Graham, because we are asking people to have a bigger equity in their home to begin with.

The biggest single cause of defaults is when your house is not worth the amount you owe on it.

By requiring additional equity, we will reduce the number of defaults among people who would otherwise default down the road, we'll bring down that 80,000, not simply by lopping 15,000 to 35,000 off, but by having other people have more equity in their home to begin with.

Senator D'AMATO. Senator Mack.

Senator MACK. Go ahead.

Senator D'AMATO. Senator Pressler. Excuse me.

Senator PRESSLER. Yes. Thank you, Mr. Chairman. My questions shall be fairly brief. I would like to ask the Secretary some practical questions.

Now, I read that you will soon be proposing to streamline the property disposition process to lessen the backlog. And I understand that it now costs HUD \$500 million a year in carrying costs for 80,000 homes.

Now, as a practical matter, we're told that these homes are being sold for about a third of what was paid for them originally, or the Price Waterhouse study at least assumes the loss of 37 cents on the dollar on each of the foreclosed homes.

To get down to the nitty-gritty, how could I buy one of these homes? Where are they for sale? How do you find out about them?

Secretary KEMP. We advertise wherever those are available.

Senator PRESSLER. Do you advertise them in the paper for people to assume the mortgage. Do people have to assume the mortgage? Is that the idea? How does it work?

Let's say it's a \$50,000 home. Who decides to sell it for less? How does it work?

Mr. WEICHER. It's appraised, Mr. Pressler.

Senator PRESSLER. You have an appraiser come in.

Mr. WEICHER. We have an appraiser come in. They appraise what this house is worth now. We offer it for sale. We advertise in the papers. If you were in Denver or in some of the cities in Texas, you could have a supplement to the paper listing the houses that we have for sale.

We indicate the address, the price, and who the broker is through whom you can buy the house.

Senator PRESSLER. How do you assign it to brokers?

Mr. WEICHER. They're selected at the area office level.

Senator PRESSLER. They're selected at the area offices.

Now, what is the practical—around the D.C. area—of course, here, homes I guess haven't gone down so much. Where are most of these 80,000 homes? Where are most of them?

Mr. WEICHER. They're in the Southwest. They're in the oil patch States—Texas, Oklahoma, on up to Colorado, Louisiana.

Senator PRESSLER. OK. Now, for example, what is the typical pattern? What, for example, would occur with a home that originally was purchased for \$70,000. And what would they sell for now?

Mr. WEICHER. Well, if they were bought for \$70,000, it would depend on how much exactly we had insured. If we insured them for \$65,000 to \$70,000, then we would wind up taking a loss on the insurance fund, which would amount to in the range of \$20,000 to \$25,000.

We would be netting \$40,000 to \$45,000. But we would also have carrying costs in that period of time. We'd be selling them for more than \$40,000 to \$45,000.

Senator PRESSLER. These are homes that the occupants paid 10 percent down for. Is that correct, about 10 percent down?

Mr. WEICHER. Less.

Secretary KEMP. Less.

Mr. WEICHER. Three percent.

Secretary KEMP. That's the problem.

Senator PRESSLER. Three percent down.

Secretary KEMP. Very low downpayment and very little equity in the home.

And I'm not speaking derogatorily about some family that goes through the trauma of having to default at all, because many of these conditions were conditions over which those families had nothing to do, that is, the economy.

Senator PRESSLER. But through what process would that family have gone? Would it be the monthly payments that they couldn't make up or would they decide to move and sell the home and then realize it was going to sell for so little?

I mean, how did the people get out of there? Why did they leave?

Secretary KEMP. For all those reasons. All of the above, Senator. There are so many variables that are introduced into the life of that family, that one would—I don't know that you can draw a profile other than we have found out that most of these, as Mr. Weicher pointed out, relatively are impacted—the impact of this is relatively confined to the six or seven States that have been so hard hit by the oil patch problems.

Senator PRESSLER. So, basically, you have to make a decision, as I understand it, whether to streamline the process of disposing of these properties. You have to make a judgment. Do you assume the houses will appreciate in value? Then you'll just hold the line?

Secretary KEMP. No, we don't do that. We don't speculate in the real estate market.

Senator PRESSLER. OK.

Secretary KEMP. We believe in moving that property.

Senator PRESSLER. As fast as you can.

Secretary KEMP. As quickly as possible, consistent, Senator, with the market conditions to which we want to be sensitive.

It is a Solomon-like decision process. We're not Solomon, but we do try to make sure that we move with dispatch and at the same time, protect as much of the integrity of the fund as we possibly can, and yet, be sensitive to the economic conditions of a market like Denver, which, if you went out and just dumped all those properties—

Senator PRESSLER. But how soon do you expect to have those 80,000 homes sold? What is your goal?

Secretary KEMP. We are moving those homes continuously. We are moving per month, on average, about 5,000 homes nationally. Unfortunately, given the problems addressed, or at least reflected in that first chart, we're getting another 5,000 into our portfolios.

Senator PRESSLER. It's holding steady at 80,000.

Secretary KEMP. It's in that area. It's in that ballpark.

Senator PRESSLER. The bottom line of my question is, I understand that you are deciding whether this fund is actuarially sound. I happen to believe that it's not.

Secretary KEMP. No, we agreed with that, Senator. That has been the whole purpose of my testimony, to tell you that, under current conditions, it's not actuarially sound. It can be put right, if we take steps right now.

And as Senator D'Amato pointed out, and quite correctly, the economy has an unbelievable impact upon the health of FHA, the S&L's, Social Security.

Does anybody doubt that Social Security went from a deep deficit to a strong surplus with the recovery of the 1980's and more men and women paying into the trust fund because they have jobs.

You put this economy through a recession, and FHA will look like the S&L crisis. That's why we must do everything possible to prevent a recession and expand this economy and then target the first time homebuyer, as Senator Cranston and D'Amato have alluded to.

Senator PRESSLER. Right. I'm in agreement with you. But I want to know, the 80,000 homes, do you propose any streamlining or changing of the disposition of those?

Secretary KEMP. Yes.

Senator PRESSLER. What?

Secretary KEMP. We will be announcing—steps have been taken as we talk to improve the disposition of the properties. We've asked our IG, incidentally, as well as other enforcement arms of the Government that have high credibility, to help us design a system that would remove any potential fraud and abuse of that property disposition. And we've made steps to do that.

But, at the same time, we are going to announce within a month the streamlining of the disposition of Federal properties that I think will be widely supported on Capitol Hill.

Senator PRESSLER. Well, now, what financing is now available to buyers of these properties?

Mr. WEICHER. It's either FHA financing, if the housing continues to meet FHA standards, or they are sold as is and you get conventional financing.

Senator PRESSLER. Are the terms more liberal or more conservative than the first financing?

Mr. WEICHER. No, it's the same process, again.

Senator PRESSLER. The same level.

Mr. WEICHER. Essentially.

Senator PRESSLER. Well, now, in this streamlining that you're going to announce, for example, what things might you do?

Secretary KEMP. John, go ahead.

Mr. WEICHER. We intend to, we're trying to work out ways to market properties appropriately to local groups who are prepared to buy a number of them in a neighborhood and renovate and sell them in that neighborhood. We've been working on that for some time.

We are proposing to move more aggressively to market the properties because we have holding costs, and if we can sell it sooner at a slightly lower price, we will come out ahead.

We're working on that kind of thing, Senator Pressler.

Secretary KEMP. What I have asked my FHA housing commissioner and assistant secretary for PD&R, and anybody else that's been interested in this very important issue, is to find a way to better market these properties, to better advertise these properties, and third, and even more importantly than the first two, move to prevent, to preforeclosure sales, so that we can prevent some of these traumatic experiences through which so many people have gone, either through counselling or the type of preforeclosure sales that would help make sure that someone doesn't end up in the red.

Senator PRESSLER. Has there been any pattern of replacing one FHA insured buyer with another FHA insured buyer?

Secretary KEMP. Have there been any what?

Senator PRESSLER. Has there been any pattern of replacing one FHA insured buyer with another FHA insured buyer, who successively fail, and then a third FHA buyer?

Mr. WEICHER. There's not a clear pattern of that, Senator. It will happen in some cases.

If a market stays low for a long time, that may happen, but it's the problem in the market. It's not so much the problem with the house.

Senator PRESSLER. Well, I think it's very important the work you're doing and the disposition of these 80,000 homes. I think that's a key issue here.

We look forward to your announcement of the streamlining functions.

Senator CRANSTON. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

Jack, in your testimony, one sentence that caught my eye. The FHA's job is to help low- and moderate-income families become first time homeowners, not first time second homebuyers.

I guess that ties in with some of the other things that you've raised, again, trying to focus FHA to assist low-income and moderate-income homebuyers.

I see that, for example, you mentioned vacation homes, second homes, investment properties.

Secretary KEMP. Right.

Senator MACK. Give me an idea, if you can, if you limit, if you no longer allow FHA to participate in that kind of financing, what kind of resources will it release to go to the low-income and moderate-income individuals?

In other words, the point that I'm trying to make, there's a concern here, I think, that because of having to make some adjustments in getting to a 2-percent figure for a downpayment, that there are going to be some people who are going to be dropped out of this.

It seems to me that the point to be made here is that by moving resources away from where FHA should not have been involved and putting it into assisting low income, you're actually going to have additional resources available.

Secretary KEMP. I don't know that it would be dramatic. But coming from the center-right of this issue, I say respectfully to my colleagues, I don't think it is—you know, I believe in recapturing the American dream for every single human being in this whole Nation, as does this committee, of course. And maybe a vacation

home is as much the American dream as that first home. But I find it hard to believe that the Federal Government should finance it.

But I don't think, other than my philosophical difference with making FHA subsidizing vacation homes or subsidizing golf courses in Florida, with all due respect to the gentleman from Florida, or California, with due respect to my friend from California, Chairman Cranston.

They got in the 1980's into coinsurance, into insuring high-rise luxury apartments. There's nothing I have taken greater joy in doing as a man of the center-right than to exercise, hopefully with a scalpel, maybe some would think a blunderbuss, an effort to tighten up the insuring of what the Federal Government should be involved in without competing with the private sector.

I believe that, both philosophically and practically and politically. And I think we've got a lot of support on both sides of the aisle, notwithstanding the debate.

So I can honestly say to people, we're not in the insurance of golf course businesses any more. We're not out—to the extent that I can personally look after every single coinsurance underwriting, we're not coinsuring high-rise luxury apartments that rent for \$1,600 a month in Key Biscayne, Florida, for instance, as an example.

And we shouldn't be underwriting—FHA should not be underwriting, in my view, speculative real estate or speculative second homes. But I don't think it would save a lot of money, by the way. I think it's prudent and responsible. I just don't think it would have a significant or dramatic impact upon our desire to build up our capital base.

Senator MACK. OK. Then just one more question along that line.

I think there have been some proposals, at least some suggestions, that there ought to be some qualifications with respect to income, that under present regulations, the amount of income, it makes no difference, providing that the mortgage that you're applying for is below the \$124,000 whatever it is.

Secretary KEMP. If you wanted a home below that ceiling, it is possible.

Senator MACK. So in the discussions that you've had so far, there have really been no discussions with respect to——

Secretary KEMP. Putting an income test to it?

Senator MACK. [continuing]. How much ability as far as income.

Secretary KEMP. I don't think you need it, Connie. I don't think you need it. I think we've taken the type of responsible steps and together we can come up with the type of end result that I think would diminish the possibility of that happening to any degree possible. Or to any degree that is dramatic, I should say.

Senator MACK. Thank you, Mr. Chairman.

Senator CRANSTON. Thank you very much.

I hope we can try to be brief in the second round so that we can get to Price Waterhouse and release Jack Kemp. I do have a couple of questions I would like to ask.

Jack, some people who I hope are overly cynical are suggesting—I hope these people are overly cynical—are suggesting that the proposed changes are a new and more sophisticated attempt to achieve

the objective of the last administration to privatize the FHA and eliminate Government support for mortgage insurance.

Secretary KEMP. Mr. Chairman, I can't help but register my—not disapproval of the question, but disapproval of—I think we've given evidence every step of the way of our enthusiastic support for the socially, as well as publicly, desirable goals of FHA. These are very prudent and responsible. They're going to be subject to all of the vicissitudes of the debate in the Senate over how to get from here to there.

But you have my personal assurance that I would not even be at HUD if I thought that that was—I'm not out to privatize. I think there are some things that should be privatized and some things that should not. But I think I've given evidence by being at HUD that I don't want to turn HUD into a giant voucher.

Senator CRANSTON. Well, good. That's a fine response and I appreciate it very much.

In your testimony, you say that "FHA's job is to help low- and moderate-income families become first time homebuyers."

I'd like to ask you this about that. Does your statement mean that you support or might support the imposition of any income limits on first time homebuyer borrowers to be eligible for FHA?

Secretary KEMP. I don't at all prefer that method. I think keeping the loan limit at \$125,000, Senator, basically, and practically speaking, effectively limits the income of the family buying the home to the range of \$50,000 or below, maybe a little bit more. But, I don't know. I'm not going to put my feet in concrete on any single element of this because I want to keep the lines of communication and negotiation going forward towards a positive result of housing legislation in 1990.

Senator CRANSTON. One concern I have about keeping the ceilings right where they are now is—I have two real concerns about it.

One, it effectively knocks FHA out of much of the California market, and I think much of the New York market, and some of the Florida market, and elsewhere.

Second, if you have adequate downpayment requirements for people up at these higher levels, wouldn't that bring less risky investors, buyers, into the FHA stream?

Secretary KEMP. I think the case that could be made on that premise is logical, Senator Cranston, and you're arguing logically from the premise. So I would want to go back to the premise upon which your conclusion is based. And that is, should we use FHA for that purpose? And that's something that, again, is going to be subject to negotiation and, of course, the debate in the Senate.

But I, too, am concerned about California. I know I was a congressman from Buffalo, New York, but I was born in California and have family in California.

We do more business in California as a percent of FHA's portfolio than there is represented by the population of California as representative of the whole country as a whole.

In other words, California represents around 10 percent of the population of the country. I think that's true, according to the last figures. And we do over 11 percent of our business in California.

That does not, however, answer your question. Your question is what do you do when California, when only 10 percent of the average homebuyers can afford a median-priced home? And I am absolutely convinced that, together—I say Democrat and Republican together—we've really got to look at those factors in the States and communities and cities that are inhibiting the production of, and the purchase of, low- and moderate-income housing.

I think there are some other issues that need to be addressed, that is, barriers to affordable housing, that have inadvertently unintended consequences, but nonetheless, despite the noble goals, have led to housing in certain areas of this country being placed out of reach of the median-priced household.

It is an absolutely tragic condition and I can assure you that, as I said the day I got my job, I wanted to work with you and Pete Wilson and work with the Democrats and Republicans to come up with ways of reducing those barriers to that very important part of the American dream—affordable housing.

Senator CRANSTON. The other aspect of that that I think we should look at together is that if you have adequate downpayments, adequate monthly payments from people who are buying homes in what are not looked upon as high brackets in California, but are in some other States, obviously, if you eliminate those people, or keep them out, you may be eliminating some of the less risky potential investors.

Secretary KEMP. Yes, I acknowledge that. I acknowledge that. My problem, my public policy, socially desirable housing hat, coupled with my philosophical hat, is at what point do we start competing with and trespassing upon the goal of a healthy private lending delivery system in this country?

I supported the \$125,000 limit. I know that isn't as good enough as you would like in California. And certainly, Boston or New York. But we have to find a way to make sure that we help people of modest income get access to homeownership and not go so high as to both compete and remove the social purposes of FHA.

Senator CRANSTON. I have one question on the second home matter.

You've indicated you oppose FHA insurance on second homes because you think Federal credit should not be used to help people who are somewhat better off.

I'd like to ask you this question—does the Price Waterhouse study suggest that FHA insurance on second homes has been more subject to default or subject to default like other homes? Or if you eliminate them, are you again eliminating one of the less risky clientele?

Secretary KEMP. I'm going to ask John to answer, Senator Cranston, if you don't mind.

Mr. WEICHER. Neither way. There is not enough second home business to make a significant difference in the fund. The Secretary's statement is essentially directed at the policy of allowing this insurance. You will not make much of a difference in that fund.

Senator CRANSTON. What is the default rate on second homes?

Mr. WEICHER. I don't know that. We don't have that information.

Senator CRANSTON. Can you get us that for the record?

Secretary KEMP. Price Waterhouse can answer that question, I'm sure.

Mr. WEICHER. They don't have that. We will get that for you.

Secretary KEMP. Goodness gracious, there's something Price Waterhouse doesn't know? GAO will know. [Laughter.]

Senator CRANSTON. It may not be a very significant part of the portfolio.

Secretary KEMP. We made our decision, Senator Cranston, purely on the policy decision, not the other legitimate——

Senator CRANSTON. Well, I'd like to know not only what the default rate is, but what elimination of it, of second homes, would do in terms of removing one of the less risky aspects at a time when we're trying to get to a sounder FHA.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman. I'm not going to go into detailed questions with the Secretary. He has been very generous with his time. I think he has helped frame a very important issue. The issue is that there is a social responsibility, on one side, which attempts to fund and provide adequate resources and opportunity for those who would otherwise be without a chance at homeownership. The fiscal side of the issue attempts to see to it that the fund is a sound one.

I believe that that is why my distinguished Chairman raises the question as it relates to some funding that might not fall strictly within the purview of the social responsibility and aspects of FHA that we think of in the traditional sense. But during these times of some very real economic turbulence, it might be necessary to question the soundness of the fund, in order to help get an infusion of dollars to shore up this fund.

I think we have to look at that. I think we've got some real problems in relation to the total economy and the housing market.

Secretary KEMP. Absolutely. I agree with you.

Senator D'AMATO. Price Waterhouse says that you need a 4.5-percent growth factor to keep this fund sound. If we don't get 4.5 percent, then tell me what happens at 3 percent or 2 percent growth.

Secretary KEMP. Well, you need to know, Al, that our proposals, we believe, and Price Waterhouse, I assume, will testify, would allow the fund to withstand a moderate—and I am Mr. No Recession. I mean, I don't believe in recessions. I think they're caused by human error and so forth.

I don't believe animal spirits cause recessions.

But having said that, I am forced to make sure that our reforms——

Senator D'AMATO. I'm for the capital gains tax, Jack. I'm for the capital gains tax.

Secretary KEMP. No, no, no. I think you can take steps to forestall economic contractions. If I didn't, I wouldn't be a very good supporter of the policies that I believe can promote wealth, not discourage it.

But we can withstand a moderately bad recession under the proposals we're making today. My lips cannot even form the words "a moderately bad recession."

To me, a recession is a disaster to the man or woman or family that loses their job. It's a depression to that family.

Senator D'AMATO. I'd like to make a little bit of a policy statement, if I might, from this vantage point. It seems to me that we've got to do everything and anything we can to protect the taxpayers, and that might mean compromising a little bit. It may be more difficult for people who have access to credit where you have a Federal guarantee.

But how do you say to the taxpayers that you're going to require them to come forward and to insure these loans if the default rate and market conditions are such that they're going to be ponying up? You're not doing the purchaser a favor.

Secretary KEMP. I agree.

Senator D'AMATO. You're not doing the taxpayer one.

Secretary KEMP. I agree.

Senator D'AMATO. That's on one side. On the other side, I would suggest that we might also have to look for ways to produce additional revenue into the fund that might necessarily always take in the primary objective.

Secretary KEMP. I agree.

Senator D'AMATO. In other words, the second home as a source of revenue. I think that that's what Senator Cranston was getting at.

Secretary KEMP. You've got to ask that to Price Waterhouse.

Senator D'AMATO. I will. I will. Thank you, Mr. Secretary. And thank you, Mr. Chairman.

Secretary KEMP. Thank you.

Senator CRANSTON. Connie.

Senator MACK. Thank you, Mr. Chairman. Just one more kind of a general question.

I think it was just last week or before last when the oversight board—we had a hearing and Secretary Brady, yourself, Chairman Greenspan were here. I think I raised then, and I just want to raise it again, having just come back from the State of Florida after about 5 days around the State. One thing I'm hearing over and over again is concern about the contraction of credit in the real estate market impacted by closing down S&L's, impacted by an aggressive policy on the part of regulators with respect to the kinds of real estate loans that are being made in commercial banks.

I guess the one concern that I pick up today that I want to mention at this point is that by the adjustments that you've made, FHA could in fact be an additional contraction of credit. It sounds like it may not be major. I think you mentioned the figure of roughly \$2 billion—\$2 billion in a \$5½ trillion economy can be rather insignificant.

My question really I guess is is there a concern, should we be concerned that this adjustment in FHA could have other ramifications with respect to the credit markets?

Secretary KEMP. I think this would enhance, not detract, from the creditworthiness and the actuarial soundness of our FHA fund, as I testified.

There is no more outspoken member of the President's cabinet than me on the subject of concern about a regulatory reign of terror or the possibility of a regulatory recession. So that is con-

stantly on my mind as I look at the unintended consequences of the loan to one borrower rolls as required under FIRREA.

There are absolutely noble goals of FIRREA. There is nobody that sat through that legislation that could possibly have hoped for some of the consequences that are now coming to the surface. No AD&C loans being made. No acquisition, development and construction loans.

To the extent that we want to be prudent, I can support cutting back. But, at the same time, the supply of credit and capital to this great housing/real estate/home buying, home building industry, upon which probably one out of every six or seven primary jobs and lots of secondary and tertiary jobs depends, is of continuing concern to the Secretary of Housing and Urban Economic Development.

Having said that, I don't think our modest and prudent and basically, I think, supportable by both sides of the aisle suggestions are going to do anything to in any way do anything other than to tighten up the fund, tighten up the insurance side of FHA's portfolio, and move out of that underwriting some of the people who have defaulted in the past.

I don't blame them because I think, ultimately, the greatest reason for a default is the losing of a job.

So I hope this Congress begins to realize—I don't mean that—but I hope that all of us realize that jobs and economic growth are inextricably linked to our housing and our homebuilding and our homeownership goals for America.

I don't think anybody yet has recognized how important it is to talk about jobs and the creation of more jobs in order to give the income streams and the assets that allow people to either afford to rent or buy that first home.

That's equally important.

Senator MACK. Again, I think it's important to stress—you use the term "regulatory recession." There's such a thing as a self-fulfilling prophecy, that if there's too much tightening down on this credit through the regulatory process——

Secretary KEMP. I don't think ours is going to be a regulatory reign of terror. Let me say that to you.

Senator MACK. OK.

Secretary KEMP. I've been sitting on the RTC Oversight Board and very concerned about it, so I'm sensitive to the question you raise. But I can assure you, I think these practices are responsible and will enhance the trust fund for the future.

I just didn't want to lose sight of the fact that a recession would throw everyone's calculations, notwithstanding the fact that I said we could withstand a moderately bad recession. God forbid, we don't want one.

Senator MACK. Thank you.

Senator CRANSTON. Thank you, Connie.

Thank you, Jack. That concludes our questioning for today.

Secretary KEMP. Thank you, Mr. Chairman.

Senator CRANSTON. Our next panel will consist of Austin Fitts, John Ols, and James Waddell of Price Waterhouse.

Secretary KEMP. Mr. Chairman, I would ask that John Weicher stay with the panel.

Senator CRANSTON. We'll now proceed with the second panel. Austin Fitts will not be testifying, but Mr. Weicher, assistant secretary, will be with us, I gather. We will hear from John Ols first, and then from James Waddell.

John, I'd like to ask you to limit your verbal testimony to 5 minutes, if you would, summarizing the material.

Thank you very much.

STATEMENT OF JOHN OLS, JR., DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY JAY CHERLOW

Mr. OLS. I'd be glad to summarize my statement, Mr. Chairman.

We're pleased to be here today, and I should mention that our analysis is strictly on a cash basis, which is the way we undertook our study last fall, on what the MMI fund result will be over the next 10 years.

We looked at raising the mortgage ceilings. We looked at reducing the downpayment requirements, allowing FHA to insure adjustable-rate mortgages with higher interest rate caps, similar to the private sector, and we analyzed the fund by using an economic model and projecting that over the period to 1998.

Since testifying in November, information has surfaced, and some of the things you heard this morning, about the actuarial soundness of the MMI fund. Many housing market forecasters are currently predicting lower rates of house price appreciation in the 1990's, as Senator D'Amato has talked about.

We have taken that information into account in developing our statement today.

In summary, Mr. Chairman, we believe that while increases in the mortgage ceiling are necessary to prevent the deterioration of the fund's balance and to allow FHA to maintain its current share of the housing market, I wish to emphasize that there is a need to proceed with caution on how high to raise the mortgage ceilings.

Since the Secretary indicated this morning that the fund is not actuarially sound, we believe that Congress should not raise the mortgage ceiling to 95 percent of a State's median house price because this action may subject the Federal Government to enormous costs over the life of the new insurance that will be created.

We believe that a decision to raise the mortgage ceiling under these conditions should be made in conjunction with a decision on how to resolve the problem of actuarial soundness so that the potential financial risk assumed by the Federal Government in the long run are adequately considered.

If the changes indicated this morning restore the fund to actuarial soundness, we believe the Congress may want to consider at that time raising the mortgage ceiling to the 95 percent level because doing so will have a positive effect on the fund's cash position and will allow homebuyers in high price States to participate actively in the FHA program, which I believe are the questions, Mr. Chairman, you were talking about at the end of the last panel.

Having said all of that, let's take a look at what our economic model shows are the possible impacts of each policy alternative on the fund's cash position.

Overall, the cash position of the MMI fund during the 1990's and the effect of the various policy options will depend heavily on actual economic conditions during the next decade.

Therefore, we analyzed the cash balance of the fund under four different economic scenarios. Briefly, these scenarios show that the fund experiences difficulties if the recent trend of lower rates of house appreciation continues through the 1990's.

For example, if the rate of house price appreciation is less than 4 percent, the fund will likely not be able to survive without U.S. Treasury assistance, even if overall economic conditions remain generally favorable.

On the other hand, if house prices appreciate at a rate of 5 to 9 percent per year, and overall economic conditions remain generally favorable, the fund's cash balance will likely be adequate to cover anticipated losses during the next 10 years.

Of the proposals we analyzed, increasing the mortgage ceiling to 95 percent of a State's median house price would have the greatest effect on the fund's cash balance and would generate the most new business. The reduced downpayment and ARM proposals that we also studied have a relatively small effect on the fund's cash position.

Besides the overall cash position of the fund and the effect of the various policy options, of equal importance, as has been brought out many times this morning, is the question of the fund's actuarial soundness. Increasing the mortgage ceiling will have a positive effect on cash balances. However, it will also increase the Government's financial risk in the form of additional insurance in force. This raises serious concerns, particularly if the fund is not actuarially sound.

For example, under the 95-percent scenario, and assuming that house price appreciation averages about 8 percent annually, the cash balance increases by \$8.2 billion in 1998. However, insurance in force increases by \$615 billion.

Before I conclude, Mr. Chairman, I would like to compliment the Department and the actions that they're taking and the actions that I've seen and read in the paper this morning. We have not had a chance to look at the Price Waterhouse study, but I will say this much, I believe that FHA and HUD are moving in the right direction. I think they're facing the problems of what's wrong with the fund, as the Comptroller General has testified in the past on the financial soundness of it.

I thank you.

Senator CRANSTON. Thank you very, very much. I appreciate your getting all that done in 5 minutes. You covered a lot of territory.

Mr. Waddell, I'm not going to ask you to limit yourself to 5 minutes, since your report is the essence of our hearing this morning. But, on the other hand, don't read the whole book. [Laughter.]

Mr. WADDELL. I promise.

[The complete statement of Mr. Ols follows:]

United States General Accounting Office

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Testimony

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Impact of FHA Loan Policy Changes
on Its Cash Position

Statement of
John M. Ols, Jr., Director
Housing and Community Development Issues

Before the
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing, and Urban
Affairs
United States Senate



Mr. Chairman and Members of the Subcommittee:

I am pleased to appear here today to discuss the results of our analyses of the impact of three proposed policy changes on the cash position of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance (MMI) Fund. This discussion will serve to update the interim results and data that we presented in November 1989 before the Subcommittee on Housing and Community Development, House Committee on Banking, Finance and Urban Affairs.¹ Our work, which was performed at the request of Congressman Gerald Kleczka, focused on the impact, over the next 10 years, on the Fund's cash balance from (1) increasing the FHA mortgage ceiling limits, (2) reducing downpayment requirements, and (3) allowing FHA to insure adjustable rate mortgages (ARM) with higher interest rate caps. To analyze the financial impacts on the MMI Fund, we developed a model for performing economic estimations of the Fund's cash flow over a 10-year period covering fiscal years 1989 through 1998.

Before presenting the results of our work, however, I would like to stress that our analysis focused on the cash position of the Fund and is therefore not an assessment of the actuarial soundness of the Fund. The difference is that a cash analysis focuses on the revenue and expenses of the Fund on an annual basis rather than on the Fund's ability to support potential losses over the entire life of the insured mortgages.

An actuarial analysis, on the other hand, would focus on whether the Fund has enough reserves to cover future losses from insurance currently in force and new insurance written. The important distinction here is that the cash balance alone cannot indicate the Fund's actuarial soundness. The volume of loans insured and anticipated future losses must also be considered to determine if policy changes (such as raising the mortgage ceiling) that result in higher cash balances, but higher potential

¹"Impact of FHA Loan Policy Changes" (GAO/T-RCED-90-17, Nov. 16, 1989).

liability, are preferable from an actuarial standpoint. In this regard, the President's fiscal year 1991 budget states that the Fund is not actuarially sound and changes, such as increasing the FHA premium, will be needed. FHA has contracted for an independent actuarial study to determine what reforms are needed to make the Fund actuarially sound.

Having said all that, let's take a look at what our model shows are the possible impacts of each policy alternative on the Fund's cash position.

SUMMARY

The overall cash position of the MMI Fund during the 1990s and the effect of the various policy options will depend heavily on actual economic conditions during the next decade. If house prices appreciate at a rate of 5 to 9 percent per year, and overall economic conditions remain generally favorable, the Fund's cash balance will likely be adequate to cover anticipated losses during the next 10 years. However, the Fund will not perform nearly as well if the recent trend of lower rates of house appreciation continues through the 1990s. For example, if the rate of house price appreciation is less than 4 percent, the Fund will likely not be able to survive without U.S. Treasury assistance even if overall economic conditions remain generally favorable. Of the proposals we analyzed, increasing the mortgage ceiling would have the greatest effect on the Fund's cash balance.

Besides the overall cash position of the Fund and the effect of the various policy options, of equal importance is the question of the Fund's actuarial soundness. Increasing the mortgage ceiling will have a positive effect on cash balances; however, it will also increase the government's financial risk in the form of additional insurance-in-force. This raises serious concerns, particularly if the Fund is not actuarially sound.

We analyzed the cash position of the Fund under four different economic scenarios. In three scenarios, we assumed economic conditions were generally favorable, while applying various rates of annual house price appreciation to each scenario--7 to 9 percent, 5 to 7 percent, and 2 to 4 percent. In the fourth scenario, economic conditions in the 1990s were assumed to approximate those experienced in the 1980s.

Assuming generally favorable economic conditions, that house prices increase at about 7 to 9 percent annually, and that the mortgage ceiling is allowed to increase with the annual increase in house prices - assumptions which constitute our base case - the Fund's cash balance will grow from \$6.2 billion at the beginning of 1989 to an estimated \$8.8 billion in 1998 (see exhibit I). At the same time, however, the Fund's insurance-in-force will more than double from \$271 billion in 1989 to \$685 billion by the end of 1998. If our other base case assumptions remain unchanged but house prices are assumed to increase at rates of 5 to 7 percent per year, as some experts are now predicting, the Fund's cash balance will remain positive but will decline to an estimated \$3.9 billion by the end of 1998.

If economic conditions instead approximate those experienced during the 1980s (which included a period early in the decade of high interest rates and high unemployment rates) and the mortgage ceiling is still allowed to increase with the annual rate of house price appreciation, the Fund's cash balance will also remain positive but will decline to an estimated \$3.8 billion by the end of 1998.

Under economic scenarios having generally favorable economic conditions but lower house price appreciation rates, the Fund would likely insure fewer loans and lower loan amounts. It would thus receive less income from premiums. As a result, its cash balance would decline--in some cases becoming negative by the end of fiscal

year 1998. For example, at an annual 2-4 percent house price appreciation rate, the Fund will be unable to maintain a positive cash balance without Treasury assistance if no policy change is made or if any of the proposals we reviewed are adopted, even if economic conditions remain generally favorable.

If the Congress decides not to raise FHA's mortgage ceiling above the \$101,250 loan limit, the Fund's cash balance would fall to an estimated \$3 billion in 1998 even under favorable economic conditions. This would occur because FHA's share of the mortgage market, under a constant loan limit, decreases as house prices appreciate above the FHA maximum limit. The decreased market share, in turn, would add less premium income to the Fund to cover future potential claims. Without increases in the maximum allowable loan limit, both the Fund's cash balance and home purchase options for homebuyers will decrease.

Of the three proposals GAO analyzed, increasing the mortgage ceiling to 95 percent of a state's median house price would have the greatest effect on the Fund's balance and would also assist in generating the most new business when compared with GAO's estimated base case. The reduced downpayment and ARM proposal are estimated to have a relatively small effect on the Fund's cash position.

Under generally favorable economic conditions and annual house price appreciation rates of 7 to 9 percent, the 95-percent mortgage ceiling proposal, we estimated, will result in a cash balance of \$14.4 billion. This would be an increase in the Fund's cash balance of \$8.2 billion by the end of 1998, and is \$5.7 billion higher than the balance we estimated if the mortgage ceiling rises only at the annual rate of house price appreciation. Because of the substantial increase in the FHA mortgage ceiling, however, the amount of insurance-in-force will more than triple to \$886 billion by 1998. Under the other economic scenarios, the

effects of raising the mortgage ceiling to 95-percent of a state's median house price are generally similar.

What does this tell us? It tells us that while increases in the FHA's mortgage ceiling to account for house price increases are necessary to prevent the deterioration of the Fund's balance and to allow FHA to maintain its current share of the housing market, there is a need to proceed with caution on how high to raise the mortgage ceiling. If the Fund is not actuarially sound, we believe the Congress should not raise the mortgage ceiling to the 95 percent level because this action may subject the federal government to enormous costs over the life of the new insurance that will be created. We believe that a decision to raise the mortgage ceiling, under these conditions, should be made in conjunction with a decision on how to resolve the problem of actuarial soundness so that the potential financial risks assumed by the federal government in the long run are adequately considered. If, on the other hand, the Fund is actuarially sound, we believe the Congress should consider raising the mortgage ceiling to 95 percent of a state's median house price because doing so will have a positive effect on the Fund's cash position and will allow homebuyers in high priced states to participate more actively in the FHA program.

In the statement which follows, I provide a more detailed discussion of our assumptions, methodology, and results. In addition, I will comment briefly on the role of FHA in the national mortgage market and summarize the comments we received from academia, government, and housing industry representatives on FHA's role. We expect to issue a report containing a more complete discussion of the policy changes' financial impacts and related FHA management issues during the summer.

BACKGROUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (P.L. 73-479). In 1948, FHA became a wholly owned government corporation subject to the Government Corporation Control Act, as amended. FHA and its functions were transferred to the Department of Housing and Urban Development (HUD) in 1965. After the transfer, FHA's staff and facilities were merged with those of other housing activities.

The basic purpose of FHA programs is to encourage improvement in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate Funds for its various mortgage insurance programs--the Mutual Mortgage Insurance (MMI) Fund, the Cooperative Management Housing Insurance (CMHI) Fund, the General Insurance (GI) Fund, and the Special Risk Insurance (SRI) Fund. Our work dealt only with the MMI Fund, which basically insures single-family homes.

GAO'S ANALYSIS OF MMI FUND POSITION

The MMI Fund is FHA's largest fund with \$271 billion of insurance-in-force as of September 30, 1989. As a result of a full financial audit, we determined that the MMI Fund had a loss of \$1.4 billion in fiscal year 1988. This loss caused the government's equity in this Fund to fall to \$1.8 billion at the end of the fiscal year. The MMI Fund provides basic single-family mortgage insurance and is intended to be self-sustaining through charging the homebuyer a premium of 3.8 percent of the mortgage amount. Let's look at why the MMI Fund is losing money.

The \$1.4 billion loss in the MMI Fund for fiscal year 1988 is mainly attributable to a \$1.2 billion increase in its loss

reserves. These reserves are necessary to account for losses on foreclosed loans that will eventually lead to claims.

Two major factors contribute to the MMI Fund's increase in loss reserves. First, the record high single-family mortgage insurance endorsements in 1986 and 1987 are entering the period in which historical evidence suggests that high claim rates could occur. Thus, foreclosures may remain at a high level. Like many private mortgage insurers, the MMI Fund generally experiences its highest rate of claims in the second and third year after the insurance is written. The claim rate usually decreases gradually after the third year and levels off after the tenth year of the policy. Given the significant level of insurance written by the MMI Fund in 1986 and 1987 (\$44.9 and \$82.6 billion, respectively), foreclosures are likely to continue at a relatively high level, at least in the near term.

The other factor contributing to the increase in loss reserves in the MMI Fund is the persistently high default and foreclosure rates in economically stressed regions, particularly the Rocky Mountain and Southwest regions. While the percentage of total MMI insurance-in-force written in these regions has remained relatively stable, claim rates, and thus losses, have been substantial in these stressed regions.

FHA POLICY OPTIONS

Our analysis focused on the cash position of the Fund at the end of each fiscal year, during the period 1989 to 1998. It shows that the cash position of the Fund is influenced by FHA loan insurance policies and economic conditions.

To conduct this analysis, we developed econometric models based on an analysis of historical trends in FHA mortgages originated during fiscal years 1979 through 1988. These

econometric models identify the relationships between claim and nonclaim terminations and a variety of explanatory variables, including loan-to-value ratios, loan amounts, the rate of house price appreciation, and other economic variables. The results from these models were then combined with a cash-flow model to provide projections of the cash position of the Fund over fiscal years 1989 through 1998.

Our analysis of claim rates developed from FHA's data base is consistent with prior studies and conventional economic reasoning. For example,

- Claim rates tend to peak in the second and third year after loan origination and then decline in subsequent years.
- Claim rates are higher for loans with higher loan-to-value ratios.
- Claim rates are lower for higher valued mortgages (within the 1989 FHA loan limit of \$101,250).
- Claim rates decline as a homeowner's equity increases through repayment of the mortgage balance and through home price appreciation.

We projected the cash position of the Fund for several policy options. These included the following: a base case in which the mortgage ceiling is raised in accordance with house price increases to enable FHA to maintain its market share; a more substantial increase in the mortgage ceiling; a reduction in downpayment requirements; and allowing FHA to guarantee ARMs with higher caps on the annual and lifetime interest rate increases.

To make these projections, we used forecasted values of economic variables developed by Data Resources, Incorporated (DRI)

in the fall of 1989. DRI provided forecasts of unemployment rates, interest rates, housing prices, and loan volumes and values. The DRI "trend" economic forecast we used predicts that the economy will perform reasonably well over the next 10 years--mortgage rates average from 9.4 to 10.3 percent; the unemployment rate does not exceed 5.5 percent; and housing prices, except for fiscal year 1989 which showed an annual increase of about 4 percent, increase at 7 to 9 percent annually over the 1989-1998 period.² The forecast values that were used are shown in exhibit III.

Base Case Analysis

In our base case analysis, we used the loan ceiling of \$101,250 for 1989 and changed this limit each year according to an index of housing prices so that, using DRI's trend economic forecast, it reaches slightly more than \$206,000 in 1998. The base case thereby assumes that FHA's market share is not eroded because of properties increasing in price so that they can no longer qualify for FHA insurance. The base case further assumes that the proportion of ARMs will remain at its current level in the FHA portfolio and that current downpayment requirements will remain unchanged. Under authority granted by Congress, HUD raised the maximum loan limit to \$124,875 for the period January 12, 1990, to September 30, 1990. Barring further congressional action, the loan limit will revert to \$101,250 at the end of that period. Because of the higher loan limit's introduction late in the our review period and its possible short duration, we have used the \$101,250 limit in our base case calculations throughout this statement.

² DRI's most recent projections show housing prices for the 1989-98 period increasing at about 6 percent annually. According to the National Association of Realtors, median house prices rose 7.4 percent annually over the 21-year period from 1968-88, although they rose by only 4.6 percent per year from 1979-88.

Under this base case scenario and using DRI's trend economic forecast, we projected the MMI Fund will have positive cash flows in 8 of the 10 forecast years. These results are displayed in exhibit I. The projections show the cash position of the Fund increasing by the end of 1998 to an estimated \$8.8 billion. Under these economic conditions, the volume of insurance-in-force for FHA is estimated to increase from \$271 billion in fiscal year 1989 to \$685 billion in fiscal year 1998. Thus, the Fund in 1998 will have greater potential exposure to loss.

This base case scenario can be compared to an analysis of the Fund's projected cash balance if the Congress decides not to raise FHA's mortgage ceiling above the \$101,250 loan limit. This projection showed that if the ceiling remained at \$101,250, the Fund's cash balance would, based on our projections, fall to \$3 billion by 1998. This projection again uses DRI's trend economic forecast. This decrease would occur because a constant mortgage ceiling would over time reduce the volume of newly-insured FHA loans in housing markets where home prices are increasing. This would cause a drop in premium revenues while claims continue to be paid. As a result, the Fund's cash balance would begin to decline by 1995.

Raising FHA Loan Ceiling to
95 Percent of State Median House Price

In our analysis of the effect of increasing the mortgage ceiling, we allow the ceiling to increase in the first year to 95 percent of each state's median house price and thereafter increase each year at the same rate at which house prices appreciate. Setting a higher ceiling in this manner expands FHA's business in very high price states, such as California and Connecticut (see exhibit IV). FHA would be able to write substantially more insurance in these states, although it still would be limited within certain metropolitan areas. By increasing FHA's volume of

business, this change would increase FHA's premium income and cash position.

The increased ceiling would provide higher cash balances for the Fund for two reasons. First, the Fund would receive greater premium income because it would insure more mortgages. On the other hand, accompanying the higher premium income would be a greater volume of insurance-in-force, meaning that the Fund would have higher future liabilities. Second, our analysis of the loans insured by FHA showed that the foreclosure and loss rates would be slightly lower for higher valued loans. According to FHA's experience over the last 10 years, larger loans tend to show slightly lower foreclosure rates and experience lower percentage losses when they are foreclosed.

Using DRI's trend economic forecast, we projected that end-of-year cash balances would grow from \$6.2 billion in 1988 to \$14.4 billion by 1998, an increase of \$8.2 billion. This compares with a projected 1998 cash balance of \$8.8 billion in our base case, indicating that with this policy change the 1998 cash balance would be expected to be \$5.7 billion higher than in the base case.³ At the same time, the amount of insurance-in-force would reach \$886 billion by fiscal year 1998 under this proposal. While raising the loan ceiling would lead to a large growth in FHA business and cash balances, lower claim rates and losses would result, given the generally favorable economic conditions and sizeable increases in house prices projected under the DRI trend forecast. (See exhibit I.)

However, several factors that might reduce the positive impact of this policy change on the Fund include the following:

³The numbers presented here do not necessarily add due to rounding. (See exhibit I).

- Analysis of FHA's data base indicates that higher value loans within present FHA limits have lower claim rates, partly because these loans have had higher downpayments associated with them. However, as the ceiling amount of the loan would be raised in high cost areas, many new borrowers either might not desire or might not be able to make correspondingly higher downpayments. Therefore, to the extent this happens, the potential risk associated with these loans would increase.
- When higher value loans are foreclosed, dollar losses might be higher than they are on lower value loans. Some private mortgage insurers contend that claim rates rise with loan size. High-value mortgages would also result in higher dollar losses, should a foreclosure occur.

As part of our study, we obtained the sometimes conflicting views of officials knowledgeable about housing issues, representing government agencies, academia, and mortgage industry organizations. Examples of the comments received in support of raising the limit to a percentage of the median house price follow:

- Raising the limit is the only way to deal with the housing affordability problem because it would increase homeownership opportunities while reducing claim rates and losses.
- Raising the limit would increase FHA's volume and market share and improve the geographical distribution of FHA loans, better insulating it from sectional risks.
- Raising the limit would have only a minimal impact on private mortgage insurers.

On the other hand, examples of comments from those opposed to the increase in the loan ceiling differ:

- Losses on high loan-to-value loans will be compounded for FHA and risks will be more geographically concentrated in places like California and some eastern states.
- As builders use the FHA ceiling as their benchmark, house prices will increase.
- The market share of private insurers will be reduced substantially.
- Linking FHA limits to area median house prices will (1) significantly increase FHA's market and risk exposure without benefitting moderate- or low-income households and (2) inevitably make FHA insurance more available to households in areas with higher real incomes than in areas with lower real incomes.

Revised Downpayment Requirement

FHA currently requires a downpayment of 3 percent on the first \$25,000 and 5 percent on the amount above \$25,000 unless the appraised value of the home is \$50,000 or less, in which case the required downpayment is 3 percent. We evaluated the proposal that FHA reduce its downpayment requirements by requiring 3 percent down for amounts at or below \$50,000 and 5 percent down for amounts over \$50,000.

For example, under this proposal, a \$100,000 mortgage would require a minimum downpayment equaling 4 percent--3 percent on the first \$50,000 and 5 percent on the second \$50,000. If this alternative is adopted and the mortgage ceiling is still increased annually according to the annual increase in house prices, under

DRI's trend economic forecast, the Fund balance would increase by \$1.7 billion from the end of 1988 to 1998--a reduction of \$0.9 billion in the 1998 cash balance from the base case. (See exhibit I.)

Adjustable Rate Mortgages

The FHA currently insures ARMs having a 1-percent annual cap and a 5-percent lifetime cap. The ARM most frequently offered by private lenders has a 2-percent annual cap and a 6-percent lifetime cap. Under current policy FHA cannot insure the preferred instrument. Therefore, very little of its portfolio is in ARMs. The third policy change we considered in our analysis was to allow FHA to insure "two-six" ARMs but to limit them to 30 percent of the FHA portfolio.

Under DRI's trend economic forecast, adoption of this policy would have very little effect on the cash balances of the Fund, increasing it by less than \$200 million compared with the base case by the end of the forecast period. This occurs for two reasons. First, we have assumed that ARMs will not represent new business but simply transfers of fixed mortgages into ARMs. To the extent that ARMs represent new business, the Fund will receive additional premium income--but experience corresponding growth in loan exposure. Second, the forecast of economic conditions includes no significant increases in interest rates. ARMs, unlike fixed-rate mortgages, increase the risk of foreclosure during periods of rising interest rates and reduce risks during periods of declining rates. With forecasts of stable rates, losses associated with ARM business would not differ substantially from those of fixed-rate loans.

IMPACT UNDER LESS OPTIMISTIC
ECONOMIC FORECASTS

DRI's trend economic forecast reflects generally favorable economic conditions and housing price appreciation rates that exceed the inflation rate--factors that are very favorable to the cash position of the Fund.

To test the sensitivity of our results to DRI's forecast, we considered alternative economic scenarios. For two alternative economic scenarios, we assumed lower rates of house price appreciation while keeping DRI's other forecast values unchanged. We used a medium housing price appreciation scenario in which house prices rise at 2 percent per year less than DRI's fall 1989 forecast. This produces price increases in the range of 5 to 7 percent annually, which are consistent with short-term forecasts produced by the National Association of Realtors and DRI's more recent 10-year forecast. We also constructed a low housing price appreciation scenario in which house prices rise at 5 percent per year less than forecast by DRI last fall. At this level, the housing price appreciation rate would be less than the overall rate of inflation. A widely publicized academic study has suggested that long-term housing price increases may be at a level below the inflation rate.

We also considered a third scenario that assumed that the country would experience a repeat of the economic conditions of the 1980s. During the early 1980s, interest rates rose to 15 percent and unemployment levels reached 10 percent. House price appreciation stayed below 3 percent per year until 1986.

Under the base policy case (loan ceiling increases along with housing prices, while ARMs and downpayment requirements remain unchanged), the Fund would fare substantially worse with alternative economic scenarios than under DRI's trend economic

forecast. Under the low housing price appreciation scenario, the Fund's cash balance would be depleted by 1996. Under the other two alternative economic scenarios, the Fund balance would shrink to less than \$4 billion. Medium house price appreciation would result in a \$4.9 billion reduction in the 1998 cash balance relative to the trend economics case; the 1980s economic conditions scenario would result in a \$5.0 billion reduction relative to that same base.

The effects of the alternative policy options under the alternative economic scenarios are generally similar to their effects under the trend economic forecast. As shown in exhibit I, under the 1980s economic conditions scenario, increasing the loan ceiling would produce a larger 1998 cash balance than would be obtained under the base case with these economic conditions, although the difference is fairly small. At house price appreciation rates ranging from 2 to 4 percent a year, the Fund would have an estimated \$2.9 billion deficit by 1998 compared to an estimated \$5.0 billion deficit for the base case. That same policy change, in contrast, would increase the Fund's projected balance to \$14.4 billion under DRI's trend economic condition, compared to a projected \$8.8 billion for the base case.

Under all economic scenarios, revising the downpayment requirement would lower the Fund's balance relative to the base case, while the increased use of ARMs shows results nearly equal to the base case for all economic conditions.

VIEWS ON WHAT FHA'S ROLE IN THE HOUSING MARKET SHOULD BE

From the time of the Great Depression through the 1960s, FHA was the nation's primary insurer of mortgage credit for the purchase of single-family homes. With the subsequent growth of the private mortgage insurance industry, policy makers began to ask

what role FHA's programs should play in the housing market and how its responsibilities should differ from those of private mortgage insurers (PMIs).

In response to conditions in the housing market and the economy in general, major changes in FHA's single-family insurance program since the 1970s included

- removing FHA's ceiling interest rate,
- increasing the maximum mortgage amount,
- encouraging the direct endorsement of FHA-insured loans by private lenders,
- collecting the full premium at loan closing and allowing the premium to be added to the mortgage amount and financed over the life of the mortgage,
- liberalizing underwriting standards to enable more people to participate in FHA's program,
- liberalizing loan-to-value ratios, and
- allowing the use of adjustable rate mortgages.

The extent to which FHA duplicates private sector activity was considered by the 1982 President's Commission on Housing. The Commission recommended that FHA should increasingly complement, rather than compete with, the private market. In the Commission's view, FHA should maintain its historic role in assisting low- and moderate-income families to achieve homeownership, while allowing the private insurance companies to take all home loans that they can and will insure.

As part of our work, we solicited views on the impact of the proposed changes from knowledgeable representatives of government agencies, academia, and industry organizations. Examples of the favorable views expressed to us follow:

- FHA should perform the same fundamental role in the 1990s that it has performed throughout its history--to provide homeownership opportunities for low- and moderate-income families. With higher home prices, it will be essential to help first-time, lower income families. But, providing this help should be done without a government subsidy.
- There is little evidence that PMIs will provide insurance to those families who can afford a downpayment of only 5 percent or less to purchase a home. Therefore, the need continues for FHA to assist these families. To do so, FHA must be able to maintain its participation in healthier markets. Without the positive effects of cross subsidization, FHA would be unable to provide assistance to riskier households.

On the other hand, we also heard from those with serious misgivings about the proposed changes. For example, we were told that

- Raising the loan limit to 95 percent of the area median house price would significantly increase FHA's market and risk exposure without proportionate benefits to moderate- or low-income households.
- It is time for FHA to refocus on its mission of serving people most in need. The best way to do this is to target FHA's assistance based on income because income is directly related to the house one can afford.

Although the answers to policy questions on FHA's future role are not easy, we believe that the bases exist for formulating policies that take into account the potential impacts on the financial viability of the MMI Fund.

FHA'S MANAGEMENT PROBLEMS

In November 1989 we testified that a number of financial management problems exist that HUD and FHA top management need to address if future losses are to be kept under control no matter what changes are made to the ceiling limits, downpayment requirements, or adjustable rate mortgages. GAO and HUD's Inspector General have been reporting on these management problems since the early 1980s. Among these problems were the need for (1) more effective monitoring of existing underwriting standards and procedures, (2) improved internal controls, (3) more diligent follow-up of audit findings, and (4) a HUD Chief Financial Officer and FHA Controller.

The new management at HUD under Secretary Kemp has taken specific steps to address and to strengthen FHA's financial position. These include

- establishing a Chief Financial Officer for HUD and a controller within FHA,
- stepping up monitoring and enforcement activities,
- performing an independent actuarial analysis of the MMI and GI Funds,
- publishing annual audited financial statements,
- improving the efficiency and effectiveness of HUD audit resolution and follow-up process,

- establishing a task force to ensure full compliance with the Federal Managers' Financial Integrity Act, and
- reviewing lender requirements to ensure that only responsible and soundly capitalized firms participate in FHA programs.

We are currently reviewing HUD's progress in implementing these management initiatives and plan to issue a report later this year.

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In conclusion, Mr. Chairman, if overall economic conditions remain generally favorable and house prices appreciate at a rate of 5 to 9 percent annually, the Fund's cash balance will remain positive under our base case and will be higher if the mortgage ceiling is raised. However, the additional insurance-in-force that this policy change will generate may expose the federal government to potentially greater financial risks. If the Fund is not actuarially sound, these risks may subject the federal government to enormous costs over the life of the new insurance that will be created, unless the problem of actuarial soundness is addressed.

Lower house price appreciation rates like those we are experiencing today will have a negative impact on the Fund if they continue. For example, if during the 1990s the annual rate is less than 4 percent, the Fund will likely not be able to survive without U.S. Treasury assistance even if economic conditions remain generally favorable.

On the basis of our analysis, we believe that while increases in the FHA's mortgage ceiling to account for house price increases are necessary to prevent the deterioration of the Fund's balance

and to allow FHA to maintain its current share of the housing market, there is a need to proceed with caution on how high to raise the mortgage ceiling. If the Fund is not actuarially sound, we believe the Congress should not raise the mortgage ceiling to the 95 percent level because this action may subject the federal government to enormous costs over the life of the new insurance that will be created. We believe that a decision to raise the mortgage ceiling, under these conditions, should be made in conjunction with a decision on how to resolve the problem of actuarial soundness so that the potential financial risks assumed by the federal government in the long run are adequately considered. If, on the other hand, the Fund is actuarially sound, we believe the Congress should consider raising the mortgage ceiling to 95 percent of a state's median house price because doing so will have a positive effect on the Fund's cash position and will allow homebuyers in high priced states to participate more actively in the FHA program. These issues will be addressed further in our upcoming report.

This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or members of the Subcommittee may have.

Summary of Policy Options by Economic Scenario

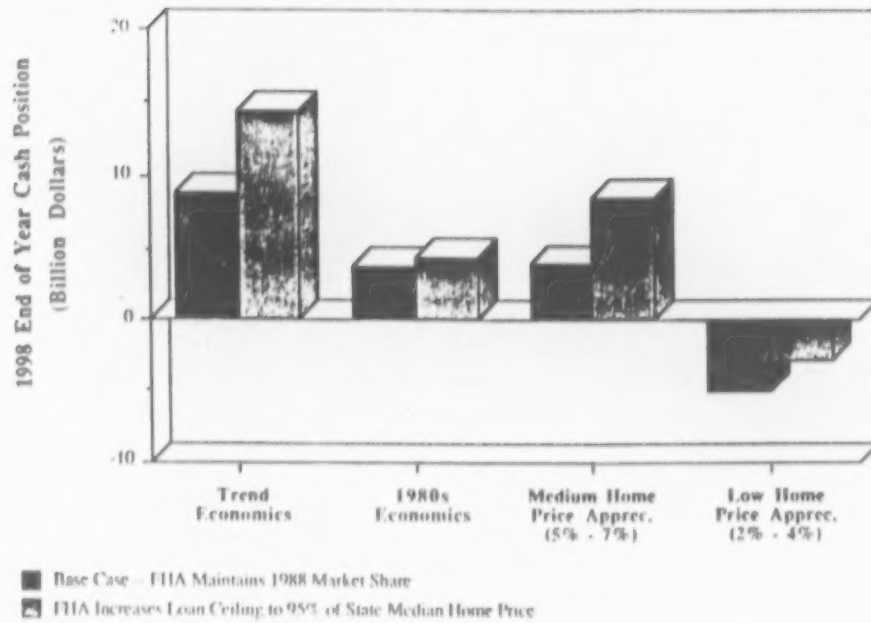
End of Fiscal Year Cash Balance (\$Million)

Policy Scenario	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Trend Economics										
FHA Maintains 1988 Market Share	\$5,586	\$5,800	\$5,361	\$5,457	\$6,443	\$6,970	\$7,192	\$7,585	\$8,186	\$8,770
FHA Increases Loan Ceiling	\$5,608	\$6,525	\$6,784	\$7,493	\$9,149	\$10,254	\$10,983	\$11,940	\$13,182	\$14,417
FHA Reduces Downpayment Requirement	\$5,586	\$5,789	\$5,309	\$5,345	\$6,269	\$6,708	\$6,800	\$7,048	\$7,484	\$7,879
FHA Provides 2/6 ARMs	\$5,589	\$5,806	\$5,401	\$5,492	\$6,384	\$6,895	\$7,184	\$7,645	\$8,307	\$8,959
1980s Economics										
FHA Maintains 1988 Market Share	\$5,586	\$5,555	\$6,058	\$7,070	\$8,095	\$8,506	\$7,258	\$7,181	\$6,527	\$5,767
FHA Increases Loan Ceiling	\$5,609	\$6,152	\$7,078	\$8,418	\$9,690	\$10,269	\$8,729	\$8,727	\$7,999	\$4,464
FHA Reduces Downpayment Requirement	\$5,586	\$5,544	\$6,021	\$7,003	\$7,999	\$8,351	\$6,977	\$6,786	\$5,975	\$2,962
FHA Provides 2/6 ARMs	\$5,589	\$5,560	\$6,089	\$6,800	\$7,477	\$7,355	\$6,126	\$6,079	\$5,560	\$3,420
Medium House Price Appreciation										
FHA Maintains 1988 Market Share	\$5,586	\$5,779	\$5,139	\$4,789	\$5,324	\$5,275	\$4,775	\$4,382	\$4,159	\$3,863
FHA Increases Loan Ceiling	\$5,608	\$6,491	\$6,523	\$6,734	\$7,859	\$8,277	\$8,134	\$8,123	\$8,323	\$8,415
FHA Reduces Downpayment Requirement	\$5,586	\$5,769	\$5,085	\$4,671	\$5,140	\$4,990	\$4,356	\$3,807	\$3,406	\$2,900
FHA Provides 2/6 ARMs	\$5,589	\$5,785	\$5,179	\$4,824	\$5,253	\$5,177	\$4,740	\$4,416	\$4,256	\$4,030
Low House Price Appreciation										
FHA Maintains 1988 Market Share	\$5,586	\$5,748	\$4,705	\$3,674	\$3,479	\$2,376	\$456	(\$1,510)	(\$3,230)	(\$5,045)
FHA Increases Loan Ceiling	\$5,608	\$6,440	\$6,032	\$5,489	\$5,768	\$4,956	\$3,138	\$1,179	(\$768)	(\$2,923)
FHA Reduces Downpayment Requirement	\$5,586	\$5,737	\$4,649	\$3,548	\$3,279	\$2,063	(\$100)	(\$2,198)	(\$4,062)	(\$6,041)
FHA Provides 2/6 ARMs	\$5,589	\$5,753	\$4,747	\$3,711	\$3,394	\$2,336	\$391	(\$1,498)	(\$3,111)	(\$4,886)

Note: End of Fiscal Year 1988 cash balance was approximately \$6.2 billion.

1998 End of Year Cash Position

FHA Increases Loan Ceiling vs. Base Case



Summary of Economic Variables

Economic Variables	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<u>Trend Economics</u>										
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9.61	9.56	9.49
Median House Price	\$97	\$104	\$112	\$121	\$130	\$141	\$153	\$166	\$181	\$198
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5.17	5.19	5.23
Ave. Nominal Loan Value	\$74	\$80	\$85	\$91	\$99	\$107	\$117	\$127	\$138	\$151
<u>1980s Economics</u>										
Mortgage Interest Rate	9.88	10.92	12.95	15.12	15.58	12.85	12.49	11.74	10.25	9.28
Median House Price	\$97	\$107	\$117	\$125	\$128	\$134	\$139	\$145	\$155	\$168
Unemployment Rate	5.23	5.83	7.16	7.78	9.87	9.33	7.41	7.20	7.06	6.05
Ave. Nominal Loan Value	\$74	\$81	\$89	\$95	\$97	\$102	\$106	\$110	\$118	\$128
<u>Medium House Price Appreciation</u>										
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9.61	9.56	9.49
Median House Price	\$97	\$101	\$107	\$113	\$120	\$128	\$137	\$146	\$156	\$168
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5.17	5.19	5.23
Ave. Nominal Loan Value	\$74	\$78	\$82	\$86	\$92	\$98	\$104	\$111	\$119	\$128
<u>Low House Price Appreciation</u>										
Mortgage Interest Rate	9.88	9.44	9.66	10.26	10.02	9.74	9.66	9.61	9.56	9.49
Median House Price	\$97	\$100	\$101	\$104	\$107	\$111	\$115	\$119	\$124	\$130
Unemployment Rate	5.23	5.50	5.40	5.22	5.39	5.37	5.28	5.17	5.19	5.23
Ave. Nominal Loan Value	\$74	\$76	\$77	\$79	\$82	\$84	\$88	\$91	\$95	\$99

Note: Rates are expressed in percents. Prices and values are expressed in \$000.

STATEMENT OF JAMES WADDELL, PARTNER, PRICE WATERHOUSE, OFFICE OF GOVERNMENT SERVICES, WASHINGTON, DC, ACCOMPANIED BY THOMAS CRAREN, SAMUEL GUTTERMAN, AND PATRICK HENDERSHOTT

Mr. WADDELL. Mr. Chairman, I'd like first to introduce the other people who worked with me on the study. Tom Craren here to my left is a partner in our Washington office, and he's responsible for our audits of the FHA. Sam Gutterman, in the first row back here, is the actuary who participated in our study. He's also with Price Waterhouse. And Pat Hendershott, to my right, is a professor of finance and public policy at Ohio State University, and an expert in the housing market. The questions that you ask will be directed to all of us.

We're pleased to appear here today to discuss our study of the financial condition of FHA's mutual mortgage insurance fund. Our study, which, as you noted, was released today, analyzes the actuarial position of the MMI fund and proposes guidelines for establishing minimum equity levels to protect the fund against adverse economic conditions.

In addition, we have identified alternative policy changes that could be adopted to achieve the equity guidelines for new loans that are insured by FHA.

In short, our report seeks to answer three questions.

First, is the MMI fund's equity sufficient to withstand expected future defaults and prepayments? In other words, is it solvent?

Second, what target level of equity should MMI strive to attain, given the risks that are insured by MMI and the risks inherent in future economic conditions?

And third, what changes to the terms of insurance would be required to achieve this target for new loans insured by MMI?

Now, you have a copy of the report and I won't go through all of the details of the analysis and so forth, but I would like to emphasize a point that was made here this morning.

First, the most significant factor affecting the fund's financial position is default. And default, in our analysis, is driven primarily by the equity position of the borrower, which is determined by the initial downpayment, the loan-to-value ratio, and by house prices over time.

I'd like to turn to the conclusions of our study and emphasize first that, while we focused on very specific numbers, to some extent, this morning, I think we all recognize that the models that we're dealing with have some range of uncertainty and some of the data that we deal with needed some editing. But the primary conclusions that we've reached are, first, the existing portfolio is solvent, if consensus economic conditions occur. Consensus economic conditions are the economic forecasts that were provided by a variety of players in the housing market, including the National Association of Realtors, the Mortgage Bankers Association of America. It also includes the Office of Management and Budget and the Congressional Budget Office.

We found that their assumptions about price inflation in the future, interest rates and so forth, were fairly consistent and they underlie our report, those forecasts of economic conditions, al-

though we have extrapolated them beyond the term for which those organizations publish the forecasts.

So, assuming those economic conditions occur, the existing portfolio is solvent. It will have a positive equity position under these economic conditions if it writes no business and uses its current resources to pay claims expected to occur over the life of the existing loans.

Second, the portfolio of insurance in force during 1990 has a positive economic value only because it had developed a substantial equity position from the business written before 1980.

The economic value of the fund fell by nearly \$5.5 billion during the 1980's, relative to its value if no new loans were insured during that period.

Its ratio of equity to insurance in force fell from 5.3 percent to just under 1 percent during that period.

Third, in our report, we propose minimum capital guidelines that will allow MMI to withstand adverse economic conditions. These guidelines are intended to result in positive economic value, even if a recession occurs or if house price appreciation is somewhat less than expected.

The minimum capital we calculate to be required, with some margin for error, is \$3.75 billion, or 1¼ percent of expected insurance in force at the end of fiscal year 1990.

Expected capital or economic value at that time of \$2.4 billion is significantly short of this requirement. In other words, the MMI fund is not currently sound.

Under the economic conditions that I described earlier, the 1990 business is expected to generate losses of \$208 million. Under a less favorable, but reasonably possible, scenario, the business will lose about \$667 million. Business written beyond 1990 of similar size and risk composition is expected to generate similar losses.

Fourth, it is crucial that the new business be written under terms consistent with these minimum capital guidelines. To comply with these guidelines and to continue the payment of distributive shares, the present value of new business each year must improve by about \$760 million. This amount will offset the \$208 million loss each year. It will allow equity to build by 1¼ percent of the net additional business and provide revenue to pay the distributive shares.

The alternative policy changes that we have identified that would achieve this result include increasing the premium from 3.8 percent, its current level, to 6 percent for all insured loans.

Second, to require an 11-percent downpayment on home value, premium, and closing costs.

Third, restructure the premium so that it would be 1.6 percent up front and one-half percent per year through the term of the mortgage.

Fourth, to charge borrowers the regular 3.8-percent premium, plus an additional annual one-half percent fee for low downpayment borrowers. This fee would be collected for a varying period, depending on the initial loan-to-value ratio of the borrower.

For example, those who originate mortgages with zero to 90-percent loan-to-value ratio would have no additional premium. Those between 90 and 93 percent would have this half a percent fee for 4

years. Those in the category of 93 to 95 percent would pay the fee for 10 years. And those with a loan-to-value ratio greater than 95 percent would pay the fee for 15 years.

The MMI fund is currently paying distributive shares on its pre-1984 business, primarily for years prior to 1979. These payments represent a distribution of capital to borrowers who have paid off their mortgages and who originated their mortgages during years that have experienced lower than expected default rates.

Discontinuation of these payments would require smaller changes to the terms and conditions of insurance than those I've outlined above.

Raising the loan limits appears to have little effect on the economic value or soundness of the fund. Most of the additional capital produced by raising the loan limits is required to protect them against default.

Moreover, one can only rationalize the minimum capital requirements that we have proposed for MMI vis-a-vis those of private insurers on the basis of the social purpose of the fund.

However, as the MMI insures higher income households, as represented by larger loans, the social purpose argument becomes less compelling and higher capital standards and insurance premiums become more appropriate.

Finally, management reforms such as those outlined this morning, could also significantly reduce losses on defaulted loans. Such reforms could improve the economic value of the fund and, as a result, implementation of these reforms should receive a high priority at FHA.

Senator CRANSTON. Thank you very much. You summarized that very neatly.

I'd like to address this both to Mr. Waddell and Mr. Ols.

This is the fourth hearing we've held in the last year on the financial strength of FHA. We're hopeful that the studies provided this committee provide a sound basis now for us to legislate with the administration in this area. Yet, we've heard some charges that your studies go too far in predicting the demise of the MMI fund. Others contend that they don't go far enough.

How do you respond to those suggestions and how confident are you that the recommendations proposed will solve the problems at FHA?

And let me start with you, Mr. Waddell.

Mr. CRAREN. First, I want to apologize, Mr. Chairman, for not having briefed you. I think you know me. I've testified before you before. It was a difficult situation. We were literally put through hoops and it was difficult. So I apologize if that created any problems. It certainly was unintentional.

Senator CRANSTON. Thank you very much.

Mr. CRAREN. I think our reaction is as follows. We may be wrong in our predictions about what the economy will do, and I think our reaction is why take a chance?

We think clearly there's exposure there. We think clearly there's a need to bring more capital into the fund. We've tried to balance the needs of the homeowners and the social purpose of the fund—1.25 percent isn't very much of a requirement and we're trying not to impair the social purpose, but at the same time shore it up.

We tried to design these so that they're flexible, so that if the economy does turn out to be better than we think, and you do this study every year and you change. But at least we're recommending not taking a chance. At least be prudent and try and retain the public purpose of the fund.

Mr. WADDELL. Mr. Chairman, if I could answer that a little differently.

We're very confident in the models we produced and their ability to predict default. What's really unknown is what was emphasized earlier this morning, and that is, how will house prices behave in the future? That's the major area of uncertainty. If they perform as expected, as we say, the fund will be solvent. But as Tom has indicated, we don't believe that we should take a chance with the value in the fund.

Senator CRANSTON. Mr. Ols.

Mr. OLS. I guess I would only add to Mr. Waddell's statement that our model on the cash side and projection for 10 years relies heavily on economic forecasts. There are those that forecast 2 to 4 percent, less than 4 percent house appreciation. Some predict 6 percent appreciation.

When you look at those scenarios, you make your judgments. If the fund is not actuarially sound, we would stand well behind it that, in fact, you don't raise loan ceilings to 95 percent of State median. But you also have to adjust it according to inflationary factors to keep you in the same market share position.

Senator CRANSTON. I take it you're both very confident that your studies give us the most accurate possible picture of FHA's financial outlook.

Mr. WADDELL. Yes.

Senator CRANSTON. Mr. Waddell, in conducting your study, certain assumptions were made in order for you to make assertions about the actuarial soundness of the MMI fund. Some of these assumptions differ from other studies or proposals or policies.

For instance, you assume a general home price appreciation of 2½ percent, whereas a study conducted by OMB economists assumes a 1-percent appreciation rate for housing over the next decade. The OMB study therefore predicts significantly more losses to the MMI fund.

Similarly, you assume that the minimum capital for the MMI should be 1.25 percent, whereas, private insurers maintain an average of about 4-percent capital. They contend that the higher capital standard is needed to protect against potential losses.

Could you explain, if you can, why your assumptions on home price appreciation and minimal capital standards differ from these other studies?

Mr. WADDELL. Sure, I'd be glad to. First, I would point out that we used 3¼-percent house price appreciation for our forecast, and I understand that you just received our statement.

Two and a half percent is the number around which we designed the adverse scenario; that is, three fourths of a percent less than our baseline forecast.

I personally can't respond to the question concerning the OMB study. I have had some discussions concerning that study, but I

don't know the basis of their price forecasts into the future. So all I can do is clarify the source of our assumptions on that point.

Mr. CRAREN. And just to add, in terms of the 4 percent, that is meant and it's judged by their ability to withstand a national depression, which is, I think, underlying our study. This is very important. We've in essence said that the MMI fund can't do that, that that would cause the terms to be virtually like those of a private insurer.

So I think the answer to your question, Mr. Chairman, is the Government does retain risk if there's a major calamity. We have not suggested that the MMI fund be designed to withstand that, because then you're impairing the social purpose. That's the balance we've tried to strike. But I think that's important to realize.

Senator CRANSTON. Mr. Ols, would you have any comment on the different assumptions?

Mr. OLS. I haven't had a chance to look at their study. I know ours, we did it with different appreciation rates of home prices, and that will have a tremendous effect on that.

Senator CRANSTON. Mr. Waddell, what special mission does FHA serve that would justify the capital standards recommended in your study?

Mr. WADDELL. I think the FHA mission is to expand homeownership opportunities, particularly for moderate income borrowers. And in view of that purpose, we have designed capital standards that are somewhat less rigorous than the private commercial markets.

Senator CRANSTON. I'd like to address this to both of you.

As you've stated, several factors go into determining the amount of risk that the MMI fund is facing. These include, among other things, the type of internal controls in place, the quality of management, the adequacy of staffing.

How would you evaluate the internal controls in place at HUD now?

Mr. CRAREN. Well, they're still pretty bad. We just had a lot of trouble at FHA, and maybe that's being too kind.

One of the things that the Secretary mentioned earlier that's true is we didn't count reforms in any way as a means of improving the fund. There's still a lot of work to do. There's no question about that. They only recently got a comptroller. There's still a lot of systems work. That will take time to improve.

I think, while I'm getting impatient, I think we ought to be a little patient with their plight in trying to fix things.

Senator CRANSTON. Have significant changes occurred since the passage of the HUD reform bill last November?

Mr. CRAREN. Yes, I think they have. Structurally, I would say, yes, if, for no other reason, people are now being held accountable for whether they're losing excess money on property. There's a controllership function in there which didn't exist before. There's more of a focus on accountability.

I think the fact that FHA has mandated actuarial studies and audits is a step in the right direction. So I would say, yes, there's been significant structural changes put in place.

Senator CRANSTON. Do you have a comment?

Mr. OLS. Yes. I would agree with Tom on that. They're moving in the right direction. They've taken a lot of actions. But I also see that they have a long way to go to get things under control. And that is one of the reasons that we say that not only the actuarial soundness, but the oversight, the underwriting standards, and monitoring what's going on in the private sector. And I think Secretary Kemp alluded to several actions they have underway in that regard. I think those are very positive steps.

Senator CRANSTON. Again, to you both. What's the capacity of the Department now to perform the historical role of FHA devising new mortgage products? Is that really now to be to devise new mortgage products that assist low, moderate-, and middle-income homebuyers?

Mr. CRAREN. It's difficult for us to answer. I would say, sure. I think they have the capacity to design new products.

I think the system is overloaded with properties right now. Somebody mentioned 80,000 a year, and that's a concern. But certainly, I think that the ideas coming out are worthwhile.

Mr. OLS. I think looking at disposal of properties is one way. But I don't know of any initiatives that are really geared to that. They're trying to get some things under control at FHA, and I think that's really what they've been working on.

Senator CRANSTON. What staffing changes do each of you think should occur in order to better monitor the mortgagees involved in the program? And has progress been made since November on that front?

Mr. OLS. Well, let me try to address that. I don't know if I can give you the specifics because we haven't looked into that directly. But I think they've made improvements. I think the chief financial officer—I think the financial audits, I think the actuarial studies to see where we're at. I think all of those are positive things.

As far as numbers of staffing, I would have to look to FHA to give you the numbers. I don't have those.

Senator CRANSTON. Do you have any comments?

Mr. CRAREN. None.

Senator CRANSTON. Mr. Ols, you say you'd recommend an increase in the FHA ceiling if the FHA fund were actuarially sound.

Could you expand on why you think higher ceilings in an actuarially sound FHA would be beneficial?

Mr. OLS. Well, a couple of reasons. One, it brings a lot of cash into the fund. It brings what we believe are some better risk loans into the fund. It also allows—if the policy was changed in that regard, it allows the FHA to serve some markets or pockets of the communities or the states that cannot be touched with FHA financing. And that is a policy decision I believe for the Congress to decide on.

All we looked at is what would be the cash values at those kind of higher mortgage ceilings. Once you determine it's sound, once you have that under control, then, in fact, I think you can look at policy changes that would refocus where FHA is going and what it's serving.

Senator CRANSTON. Is it your judgment that adoption of the administration's recommendations would be beneficial?

Mr. OLS. I think they're a step in the right direction. Without looking at Price Waterhouse's detailed study, I don't know all the considerations that went in and all the assumptions, but I think they're moving in the right direction in that regard, with trying to increase the downpayment levels or make more equity by a borrower because everybody in the private sector, as well as the Government, will agree that with less equity or less downpayment, you're going to walk away, especially if house prices don't go up.

Senator CRANSTON. Do you think a legislative package that includes these recommendations would be strengthened by inclusion of higher FHA ceilings with higher equity requirements?

Mr. OLS. Yes. I guess my general answer would be yes. I think those would be good things to require. And again, I have to look at the analysis behind Price Waterhouse, how they projected all of those out.

I really don't have the details behind their study. I read them this morning and looked at them and tried to come to a conclusion that, yes, these are some positive steps.

Senator CRANSTON. You've had the same problem we've had.

You've testified that FHA's share of the mortgage market under a constant loan limit decreases as home prices appreciate above the loan limit. At the same time, you say that we should proceed with caution in raising those mortgage ceilings.

How do you recommend we increase the limits while proceeding with caution?

Mr. OLS. You could use an indexing system. You could use the inflation factor, which might be 4 percent or 3 percent. Just to keep FHA in the market of holding their line right now, and that's really what I see.

We would index our study of using a 1987 figure of \$101,250, which was the ceiling at that time, or put into effect. And you index that over the last 3 years, you would come out with a new ceiling of about \$115,000, not much underneath where we are right now in the proposals that are being considered under the Congress of \$124,000.

Senator CRANSTON. What increase would you recommend in order to sustain the current market share for FHA?

Mr. OLS. Well, based on an inflation factor, to hold the 11 percent, you probably would only have to be at \$115,000. But I don't know for the difference in where the law is now, dropping back from \$124,000 just gets everybody confused on the open market on what really is the rate, what is the ceiling, how long is it in effect?

I guess I would have no objection to the \$124,000.

Senator CRANSTON. Turning now to Mr. Waddell, or whoever wants to answer for Price Waterhouse.

Am I right in understanding that your analysis suggests that raising the FHA ceiling would be relatively neutral, neither helping, nor hurting?

Mr. WADDELL. Yes, that's correct. The value of the business that's above the cap is not substantially different from the value of the business that's just below the cap.

That's the conclusion of our analysis.

So were you to lift the ceiling, the actuarial value, the value in the fund would not change substantially.

Senator CRANSTON. Would placing higher downpayment requirements on the larger mortgages help even more?

Mr. WADDELL. Well, certainly, anything that you do to increase downpayment requirements will improve the quality of the credit.

Senator CRANSTON. Let me ask anybody at the table one question on that.

If we do raise the mortgage downpayment requirement along the lines of what we've been discussing, how many people do we then eliminate from the program that would otherwise be able to get into it? Do you have any studies that indicate anything on that?

Mr. WADDELL. I think we've looked very generally at the effects of some of the changes that were proposed this morning and we've compared those to the private markets.

I think what we've concluded is that even after some of the changes that were made, the FHA fund would still be competitive with the private mortgage insurers. And on that basis, we wouldn't expect a substantial amount of shifting.

Senator CRANSTON. Does Price Waterhouse think the Administration package will achieve actuarial soundness, and do you have any specific suggestions to strengthen the administration proposals?

Mr. WADDELL. I think we've concluded that the administration's package will meet our 1¼-percent target that we establish in our report. As has been emphasized, we believe that is a minimum target. I said earlier that the capital to insurance in force ratio at the start of the 1980's was 5.3 percent.

Certainly, if economic conditions are as bad in the 1990's as they've been for the housing market in the 1980's, the fund would still be in trouble.

So we would regard the 1¼ percent figure as a minimum number. And I emphasize that to you. There's no reason that the capital in the fund should not go above that figure.

Senator CRANSTON. Thank you very much. Al.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. OLS, you stated that if the fund is actuarially sound, raising the mortgage limits would strengthen the fund. But if the fund is not actuarially sound, raising the limits may hurt the fund.

Profound. What are you saying?

Mr. OLS. What we're talking about is.

Senator D'AMATO. It's not actuarially sound, is it?

Mr. OLS. Not as I heard this morning. I didn't know that until we walked in here this morning.

Senator D'AMATO. You didn't know that?

Mr. OLS. No. We have not done an actuarially soundness study of FHA. We looked at strictly the cash flow over the 10-year period.

Senator D'AMATO. You heard my question before. You said that as of February, 1990, we had \$1.8 billion in reserves. Price Waterhouse came up with a different figure of \$3.2 billion as of a year and a half later, which was illustrated on those charts.

And then I was told that we were using two different figures. One was actual cash—is that right?—a standard accounting practice, as opposed to market value.

Mr. CRAREN. Can I address that, Senator D'Amato?

Senator D'AMATO. Yes.

Mr. CRAREN. I don't know if I can clear it up because I'm an accountant and there's the old saying that accounting is the only discipline that makes the simple complex. And I think that's the case here.

The basic difference is this—GAAP accounting is one way of measuring it and it tends to try to be conservative.

Senator D'AMATO. Mr. Ols did GAAP accounting?

Mr. CRAREN. The other accounting we did. I'm not familiar with what Mr. Ols did.

Mr. OLS. They're talking about the financial report, the one issued on the financial statements of 1988.

Mr. CRAREN. Just in comparing—earlier, you mentioned the \$1.8 billion in the report, which I believe is the GAAP equity number. We presented a number here today that's \$2.6 billion, which is the economic value.

The difference is simply this. The economic value is the present value of future revenues that you can count. And GAAP accounting, tending to be conservative, says you can only recognize future losses; you cannot recognize future income.

So it won't allow you to recognize the additional \$700 or \$800 million until the future.

I warned you, it's making the simple complex, but that really is the difference.

Senator D'AMATO. Well, then, let me go a step further. Let's suppose that instead of using your market value technique to develop the equity, you were to use GAAP accounting.

What would you estimate the fund to be? You must know that.

Mr. CRAREN. Well, according to the last audit, it was worth \$1.8 billion, as of the end of 1988.

Senator D'AMATO. That was 1988. What would it be worth at the time of the audit that you just completed, this audit [indicating]. What would it be worth?

All the television cameras are gone. What would it be worth?

I mean, you have to understand that somebody's going to ask this.

Mr. CRAREN. No, I understand.

Senator D'AMATO. I mean, you don't think the balloon's going to be kept without somebody asking you, right?

Mr. CRAREN. No, I'm certain you'll ask us.

Senator D'AMATO. Well, then, let me ask you. What is it under GAAP accounting rules? You know what it is. Now, what is it?

Mr. CRAREN. As of today?

Senator D'AMATO. Yes. As of the time you completed the audit. You gave a value of \$2.6 billion as of what day?

Mr. CRAREN. As of the end of fiscal 1989.

Senator D'AMATO. So as of the end of fiscal 1989, what is it?

Mr. CRAREN. Something less—\$1.6 billion, perhaps. Something less than \$1.8. I don't know. The financial audit has not been completed. That is an actuarial study.

Senator D'AMATO. How long would it take you to complete that?

Mr. CRAREN. It's been ongoing with GAO. It will be done in a month or so, I would say.

Senator D'AMATO. Are you saying to me that you can't give me a GAAP accounting of what the value of the FHA portfolio, or whatever, is right now?

Mr. CRAREN. I could give you a number. I don't know how accurate it would be. There have been substantial audit adjustments in the past at MMI. And I don't mean to mislead you, Senator. We will know the number. I find that their financial records often need adjustment at MMI, so I'm hesitant about giving you the number until we know for sure about the audited figures.

I don't know how else to put that. Again, I don't mean to mislead you.

Senator D'AMATO. Did you look at the February report that the General Accounting Office completed? I'm sure you must have. You worked with them on this.

Mr. CRAREN. Right.

Senator D'AMATO. This job, [indicating]. 1988 financial statements, Federal Housing Administration, GAO. February, 1990.

Are you aware of that?

Mr. CRAREN. Yes, I'm aware of that.

Senator D'AMATO. And that's where they came up with a figure of—let's see—\$1.8 billion. Page 3.

Mr. CRAREN. That's correct.

Senator D'AMATO. Do you want me to give you a copy of this so that you can look at it?

Mr. CRAREN. I remember it.

Senator D'AMATO. OK. Now, is that accurate?

Mr. CRAREN. That was accurate at the end of 1988, that's right.

Senator D'AMATO. Well, do you think that in the last year and a half, or the last year—you take this through 1989, so it's another year, right?

Mr. CRAREN. Uh huh.

Senator D'AMATO. And in that last year, has that fund gone up or down?

Mr. CRAREN. Probably down.

Senator D'AMATO. Probably?

Mr. CRAREN. Probably down.

Senator D'AMATO. How about absolutely?

Mr. CRAREN. Well, again, until it's completed—

Senator D'AMATO. Aw, c'mon, now. C'mon.

Mr. HENDERSHOTT. Senator, might I respond?

Senator D'AMATO. Now, wait. No, no. He doesn't need a bailout.

Mr. CRAREN. There's a good possibility it's gone down, yes.

Senator D'AMATO. Now, I can't believe that at this point in time you would come and give us this package and give us an estimate in relation to market value, but you don't yet know if you are going to use the generally accepted accounting principles so you don't know what that figure is.

By the way, you can go back and see that I was very good with the Secretary, because I didn't ask him any of these questions. Right? Huh? All right. So I wasn't roughing him up.

Tell me.

Mr. CRAREN. Again, the purpose—

Senator D'AMATO. You mean, Price Waterhouse doesn't have that figure? The same figure, you did one way here, but you did it another way here.

Suppose I suggested to you that you don't want to come out publicly with what that figure is, as of 1989. Would that be unfair for me to suggest that? I don't mean this to be personal with you. I find you very engaging.

Mr. HENDERSHOTT. Yes, it would, Senator. Yes, it would be unfair.

Senator D'AMATO. OK. Do you have any idea what it is? Did you do this?

Mr. HENDERSHOTT. I did, indeed, participate in it, in this study. The \$1.8 billion number is mentioned one time in the study, the GAAP accounting number.

Senator D'AMATO. I don't understand why you do GAAP accounting here, but you don't do GAAP accounting here [indicating].

Why?

Mr. HENDERSHOTT. I did not participate in the GAAP accounting study. But if you're interested in financial solvency, you're interested in economic accounting, not some funny numbers that the accountants make up. You're interested in real numbers.

Senator D'AMATO. Well, wait a minute now.

Mr. HENDERSHOTT. What we have done here is we've tried to calculate sort of what the value of the FHA fund is as a business. If you were to sell FHA in the private sector right now, say, would you buy this one—the name is Pat Hendershott from Ohio State University, sir.

If you were to sell this fund right now, but tell the new buyer that they could not write any more business, they've just got the old business, nothing new, supposedly, it would sell for roughly \$2.6 billion. That's its economic value.

Accounting numbers—well, you must know after this S&L stuff, accounting numbers can be anything. They aren't real numbers.

What we're trying to come up with is our best estimate of real numbers. And that's why this whole report is about economic value. It's not about GAAP accounting numbers.

Senator D'AMATO. You can really predict economic numbers. Let me ask you something. What if I were to say to you that you had to plug in some number?

Mr. HENDERSHOTT. We've plugged in a million numbers.

Senator D'AMATO. You'd better believe. You'd better believe.

Mr. HENDERSHOTT. They keep asking us to do that.

Senator D'AMATO. A 4.5-percent growth rate will make this actuarially sound—4.5 percent as it relates to market value in the housing industry?

Mr. HENDERSHOTT. Right. I think that's probably right.

Senator D'AMATO. Incredible.

Mr. HENDERSHOTT. There is an exhibit here that does just that.

Senator D'AMATO. By the way, do we make a judgment as to whether or not that's what the market is and will be?

Mr. HENDERSHOTT. Sir, if you're engaging in an economic business, which, if you're insuring real world stuff, what's going to happen to the insurance depends upon what happens in the real world and you have to make your best assumptions.

Senator D'AMATO. What is your best assumption about what's going to happen in the real world? Does this report do that? I haven't studied it. Does it do that?

Mr. HENDERSHOTT. Yes, it does.

Senator D'AMATO. What does it assume?

Mr. HENDERSHOTT. Our assumption regarding house prices is 3¼ percent.

Senator D'AMATO. A 3¼-percent growth?

Mr. HENDERSHOTT. A 3¼-percent growth, right. And if you look at page—have you got the report there?

Senator CRANSTON. May I interrupt for one moment?

Senator D'AMATO. Sure.

Senator CRANSTON. I have to go to the Senate floor, so I just want to indicate one thing about where we're headed, and Senator D'Amato will complete the hearing.

The subcommittee will be carefully reviewing your studies as we were unable to do, as has become well known before this hearing. In a few days, we'll have a much better understanding of what you found in detail and what you're recommending. We count on your help in that review.

What we're going to do is hold a follow-up hearing in a round-table format in a few weeks, as soon as we can prepare for it. Possibly on June 19. At that hearing, various industry and community groups will be testifying. I'm asking GAO and Price Waterhouse to participate in that hearing to explore questions in more detail in some ways than we've been able to do today.

We thank you for your helpfulness today and we count on your continued helpfulness. And I want to thank everybody who has been in attendance.

Now, you go on and you wind up the hearing.

Senator D'AMATO. Thank you, Mr. Chairman. I think they'd rather that I went to the floor.

You said that you did assume market value increase of 3.25 or 3¼ percent.

Mr. WADDELL. That's house price appreciation.

Senator D'AMATO. Yes, house price appreciation. You have to understand, I haven't seen this. So you have to bear with us. Is there another area where you say or indicate that unless the market appreciation of the prices on houses is, what, four point something?

Mr. WADDELL. 4.6 percent, yes.

Senator D'AMATO. 4.6—there's going to be a problem.

Mr. WADDELL. That's correct. That's correct.

Senator D'AMATO. So what your report, in essence say is that you're predicting that it's going to be a problem.

Mr. WADDELL. That's right. We say that quite clearly. I thought I said that in my opening statement.

Senator D'AMATO. I wasn't here for it.

Mr. WADDELL. I beg your pardon.

Senator D'AMATO. No, I beg your pardon. I'm sorry that I wasn't here to hear that.

Mr. WADDELL. We indicate that the fund is unsound.

Senator D'AMATO. You say the fund is unsound.

Median Home Prices by State (1988)

Alabama	\$82,300	Kentucky	\$59,700	North Dakota	\$67,900
Alaska	\$100,100	Louisiana	\$81,200	Ohio	\$70,900
Arizona	\$100,700	Maine	\$98,300	Oklahoma	\$67,900
Arkansas	\$71,200	* Maryland	\$111,600	Oregon	\$72,400
* California	\$162,700	* Massachusetts	\$159,000	Pennsylvania	\$81,100
Colorado	\$89,800	Michigan	\$78,800	* Rhode Island	\$130,500
* Connecticut	\$171,300	Minnesota	\$95,800	South Carolina	\$83,900
Delaware	\$83,500	Mississippi	\$71,000	South Dakota	\$72,800
* District of Columbia	\$133,000	Missouri	\$74,600	Tennessee	\$79,700
Florida	\$90,900	Montana	\$73,900	Texas	\$80,000
Georgia	\$92,800	Nebraska	\$65,500	Utah	\$81,300
* Hawaii	\$170,700	Nevada	\$92,900	Vermont	\$95,800
Idaho	\$79,800	* New Hampshire	\$134,500	* Virginia	\$122,400
Illinois	\$91,800	* New Jersey	\$155,100	Washington	\$95,600
Indiana	\$59,200	New Mexico	\$70,300	West Virginia	\$64,600
Iowa	\$63,200	* New York	\$149,200	Wisconsin	\$73,300
Kansas	\$73,300	North Carolina	\$86,000	Wyoming	\$83,400

* States with median home prices above FHIA's current loan ceiling.

Mr. WADDELL. Primarily because the new business being written adds a negative value to the fund. It essentially will lose money over the term of its insurance.

Senator D'AMATO. You're saying the new business. What about the existing business?

Mr. WADDELL. The existing business—if you take the assumptions—

Senator D'AMATO. Suppose we weren't to do anything else. We were not going to write any more business. We stopped today.

Mr. WADDELL. You really should have heard my opening statement. It covered this perfectly. [Laughter.]

Senator D'AMATO. It was brilliant. [Laughter.]

Mr. WADDELL. If you take the insurance in force currently—

Senator D'AMATO. Hey, listen. At least you got one guy here. How many did you have here when you were testifying, anyway? Two? Three? I came back to listen. All right.

You're doing well, Waddell. C'mon.

Mr. WADDELL. If you take the portfolio today.

Senator D'AMATO. Right.

Mr. WADDELL. Don't write any more business. And you get the kind of economic conditions that we assume is our baseline. And incidentally, those came from the National Association of Realtors, the Mortgage Bankers Association—they're pretty much consensus about where the market is headed right now, or at least those organizations indicate similar numbers—you will get a positive value associated with the existing business.

Senator D'AMATO. In other words, if there's a 3 percent appreciation, or thereabouts, for housing in the future, and you don't write any more business, the fund will make it.

Mr. WADDELL. The fund will limp through, that's right. And what we are concerned about is that if you're off slightly, if you go down to 2½ percent house price appreciation rather than 3¼ percent, the economic value of the fund, the value of the business you're writing is severely negative and the fund will not make it under those conditions.

Senator D'AMATO. All right. Lets suppose that there's no appreciation. There is no appreciation for the next 2 years and we don't write any new business. The fund is still going to be losing money.

Mr. WADDELL. That's correct, yes. I'm assuming in my answer that you're going out 30 years. If you have 2 years of zero house price appreciation—

Senator D'AMATO. Yes.

Mr. WADDELL [continuing]. Then the value of the fund will become zero, yes.

Senator D'AMATO. In 2 years?

Mr. WADDELL. No. The economic value, again, the value of the business taken out over its term, the present value of that will be zero. The cash will still be there for some time.

Senator D'AMATO. You put it in terms of 30 years. Would the fund be able to sustain itself if over, let's say, the next 3 years you had zero growth in relation to the prices of housing, which stood flat basically for the next 3 years and thereafter, began to take off?

What would happen at the end of 3 years?

Mr. WADDELL. Are you referring to the equity of the fund or are you referring to the cash position of the fund?

Senator D'AMATO. The cash position of the fund.

Mr. WADDELL. I'm not sure. I'd have to run a simulation for you.

Senator D'AMATO. Could it limp through, do you think, 2 or 3 years with no growth, no appreciation in housing, if we were to stop writing?

Mr. WADDELL. I wouldn't want to hazard a guess.

Senator D'AMATO. OK. Let me ask you this. As an indispensable part of your exercise in coming up and doing all of this, didn't anybody ask you to make an analysis and a projection as to what new business undertakings should be, the manner in which you conduct the FHA from here on out, so that you can begin to deal with this problem?

I mean, isn't that implicit in part of the charge?

Mr. WADDELL. Let me——

Senator D'AMATO. Do you want me to rephrase that?

Mr. WADDELL. Yes, could you, please?

Senator D'AMATO. Let me rephrase it, OK, because I stated it most inartfully.

It would seem to me that a very important consideration would be what business adjustments should be made in relation to the management of FHA. In other words, who do you write for? What should the limits be? What should the downpayment requirements be? What should all of the financial aspects be?

I mean, there are certain things you haven't even touched on. But isn't that part of it? Zero growth, zero appreciation in housing over the next 2 or 3 years, is I think, much more realistic, much, much more realistic. I want to know where people are going to predict to you that housing prices are going up. Maybe in selected regions, but in most of the regions that I'm aware of, housing prices are going down. And dramatically. And they're going to continue to do so.

Why are we kidding ourselves and kidding the people?

So let's suppose we can't predict, and I don't think that we can with any kind of accuracy, what the market's going to be. It's a flat market, all right? Whether it's up 3 or down 3, it's basically flat.

Wasn't part of your charge to develop or to make recommendations that would help to deal with the problems that you have in the management of FHA?

Mr. WADDELL. We have made the recommendations with respect to the insurance that's written.

Senator D'AMATO. In other words, that's the increase of one-half percent?

Mr. WADDELL. Well, it's more than that. It's one-half percent over some period of time.

Senator D'AMATO. I'm not disparaging that. Well, if you were to undertake all of those recommendations that you put in here, and you have a flat market, do we limp through for the next 3 years?

Should we consider not writing any FHA insurance?

Mr. WADDELL. Well, I guess our conclusions are in the study that the market appears to expect house prices to appreciate at 3¼ percent.

Senator D'AMATO. Over 30 years?

Mr. WADDELL. No. They project over 5 years and we've extrapolated it forward from there.

Senator D'AMATO. Over the next 5 years, you're projecting an average increase of 3¼ percent.

Is that right?

Mr. WADDELL. That's right, with some variation by region. So that some places are not quite as high as others.

Senator D'AMATO. Did that economist help you?

Mr. WADDELL. If he turns to the right page, he will. [Laughter.]

Senator D'AMATO. No, did he participate in that assumption? That's economic now, right? You were disparaging those economists before.

Mr. HENDERSHOTT. Yes, I did participate in some of the assumptions. Sir, I'm not sure where you're getting your appreciation rates from. I mean, I understand that some areas——

Senator D'AMATO. I'm not getting them from anywhere. I'm taking them from you.

Mr. HENDERSHOTT. No, no, no. You're the person who's continually saying that prices are going to be flat. They're going to be going down in not just the Northeast, but a lot of regions.

Senator D'AMATO. You mean that's not the case today?

Mr. HENDERSHOTT. I don't know what the case is today, this month. But if you look at——

Senator D'AMATO. What about last month?

Mr. HENDERSHOTT. If you look at how house prices have done in the last year, if you look at Freddie Mac's home resale index, there are a lot of indices, I think, if you look at the National Association of Realtors' numbers, which we have problems with, but I think if you look at most house price data, they suggest that house prices are not flat. They may very well be flat in some areas, but——

Senator D'AMATO. Oh, really. We should have a hearing just on that. And I want to tell you something—we're all the product of our own environment. And maybe it's just because——

Mr. HENDERSHOTT. They're doing real well in Columbus, I think.

Senator D'AMATO. Well, we're not doing too well in Long Island. And we're not doing too well in New Jersey. And we're not doing too well in Connecticut. And Pennsylvania, that was a hot, hot market. It's beginning to come down. And I don't think that you're going to find that most of New England is doing too well.

Mr. HENDERSHOTT. That's the premise, Senator.

Senator D'AMATO. And I have to say that they're not doing too well in Oklahoma. And they're not doing too well in Dallas.

Mr. HENDERSHOTT. I suspect they're doing decent in Dallas this day. Sure, they're doing badly in the Northeast, but they had done very, very well there. They've done very badly in Texas. I suspect they're going to do reasonably well in Texas for the next year.

—Senator D'AMATO. What about when OTS or RTC begin to sell properties? And I think the first sale is coming up—is it coming up sometime in mid-June, June 25 or something? Our housing commissioner is back there.

Isn't there some disposal? Isn't RTC going to do something pretty soon, Commissioner Fitts? Are you aware of that?

Mr. WEICHER. They're having an auction, but it's not houses, Senator. It's commercial property.

Senator D'AMATO. Commercial properties. When do they start with their houses?

Mr. WEICHER. It's my understanding that they're not planning an auction of houses, but they are selling houses as there are buyers.

Senator D'AMATO. They're undertaking that right now?

Mr. WEICHER. Yes.

Senator D'AMATO. Well, I'm just going to suggest to you that we're in extraordinary times. It seems to me that assumptions are being made about the prices in the housing area, and particularly about the FHA housing stock that you're talking about which apparently is going to be most at risk, is not one that is going to appreciate.

But that's anybody's guess and that's why we have economists and politicians, and both of them generally make predictions that you wouldn't want to bet your life on.

Mr. HENDERSHOTT. Sir, if you've got the report there, on page 28, we have a graph that shows the sensitivity of existing fund, page 28, where we've got three curves. The middle curve is the one with our baseline assumptions. We've got the house prices on the horizontal axis, and we say at $3\frac{1}{4}$ percent, you get the fund being worth the current \$2.6 billion.

This graph indicates that even if inflation dropped to $1\frac{1}{4}$ percent, the existing fund would still maintain positive value. That's $1\frac{1}{4}$ percent forever.

Now, if you had that, plus more severe regional stuff, you can get this negative number.

So it is certainly possible to get the existing business negative. The problem that we're really addressing is that we're writing new business that is already negative. I mean, when you put the new business on the books under reasonable assumption, it loses money. Under these bad assumptions, it loses a lot of money.

We need to change new business.

Senator D'AMATO. That there is an absolute need for immediate reform is one of the conclusions that you're making.

Mr. HENDERSHOTT. Exactly.

Senator D'AMATO. Regarding the proposals that you have put forth, are they minimum proposals, in your opinion, to turn that situation around?

Mr. WADDELL. Yes, they are. The $1\frac{1}{4}$ percent standard that we've highlighted and around which we've designed our proposals, we believe to be a minimum.

Senator D'AMATO. And the proposals for the modest increase in the insurance cost and downpayment, et cetera, and the other recommendations, are those minimum recommendations?

Mr. WADDELL. Yes. Those are designed to meet that minimum standard, correct.

Senator D'AMATO. In other words, if you had your druthers, you'd even go more?

Mr. WADDELL. It becomes a policy issue at that point.

Senator D'AMATO. I didn't hear you.

Mr. WADDELL. That becomes a policy issue.

Senator D'AMATO. So if you had your druthers, would you recommend possibly increasing some of the requirements for those who are purchasing houses under the present program?

Mr. WADDELL. I can't say. The responses that we've made on our view of actuarial —

Senator D'AMATO. You've got the economist. He's really uptight because you're not giving the political answer that he wants you to give and you're being more candid than you should.

But that's all right, Waddell. You're doing all right. You've got to be true to yourself, too, you know.

Mr. WADDELL. Thank you, Senator.

Senator D'AMATO. Whether it's at my urging or anybody else's, sometimes you've got to stand up and say what's right. That's pretty hard. It's not always easy.

My friend, Mr. Ols.

Mr. OLS. Yes, Senator.

Senator D'AMATO. You've been studying this for a while now.

Mr. OLS. Yes. We worked on a model last fall and developed some base case scenarios.

Senator D'AMATO. Have you been suggesting working with HUD in relation to putting forth some constructive suggestions as to how management should deal with the FHA? If you're going to continue in this business, what do you recommend to improve the system because the system is not doing what it should be doing. You're making some lousy loans. Why do you make lousy loans? Well, we've been doing it. And you continue it.

I don't mean you, but you're the cop on the beat. What the hell do you say to them? Have you been looking at this? I'm going to ask staff to direct a review, a GAO review, concerning what policies you have found in the administration of the program to be deficient and what should be changed?

Is that the kind of charge you need?

Mr. OLS. No, we don't need that charge. Let me address that, though.

Senator D'AMATO. Will you undertake that review for me?

Mr. OLS. Yes, we would be glad to.

Senator D'AMATO. Would you?

Mr. OLS. Yes.

Senator D'AMATO. And you'll meet with Grace Morgan. I mean, there will be people who will be in consternation about me asking you this.

Mr. Waddell, you know that we're making mortgages that, given the conditions that exist, are going to run us into the hole. My gosh, what do we do to stop that? In addition to just raising some of the rates, I think there are some other practices that have to be adjusted.

For example, is HUD considering establishing performance standards in evaluation of lenders? Are we doing that?

Mr. OLS. I don't think so. But I would like to address some of your comments?

Senator D'AMATO. But you know what I'm saying, right?

Mr. OLS. Yes.

Senator D'AMATO. I mean, if you've got a guy who's a lender and he's continually bringing in people who are bad risks, at some

point in time, don't you have to say, why the heck are we doing business with him?

Does that make sense?

Mr. OLS. Yes.

Senator D'AMATO. All right. Go ahead.

Mr. OLS. Yes. A couple of things. One is that we are working with C. Austin Fitts and her staff, and I think it's been a great relationship that we've developed working with them in the financial audits that we've undertaken.

The Comptroller General has testified several times, talking about the actions on the financial audits, talking about the financial officer. I think those are improvements that are coming. Those have been worked on as of last fall, into the fall and into this year.

One of the things we have and we'll be reporting in the near future is an analysis that we did on loan servicing appraisals and loan originations on monitoring activities that we think that we can identify some improvements, and that should be coming out shortly. We've shared those views with Ms. Fitts on what ought to be done, not just holding them until we release the report. We want the action taken now.

The other thing that I have underway right now is what I refer to as a HUD report card which will come out sometime in August, maybe the first week of September, that's going to tell you what's going on to correct the problems that have come and emerged over the last year and a half. And that will be a status report on things of what they're doing, what they're not doing, what still needs to be done.

Coupled with that is one of the things, and you alluded to it just now, is what we refer to as performance indicators. I think those are some positive things that need to be undertaken.

And we're going to look to see if we can identify what kind of indicators could be brought to bear to manage their operation, not only in FHA, but other programs that are ongoing.

Senator D'AMATO. Look, I've been a great supporter of FHA because I think it's important to give people an opportunity at homeownership. But we're going to jeopardize this whole thing if we don't establish basic, fundamental principles that are adhered to in order to protect the program and the taxpayer. Otherwise, we're going to lose both. And the taxpayers are going to be furious, and they will have a right to be.

I know that you've gotten into a quagmire. C. Austin Fitts walked in there and couldn't find the records. You didn't even know the properties that you owned. You didn't know the people that owed you these monies. So I understand that we're moving towards this.

As a person who's been a great supporter of the program, I must now begin to ask questions—should we, given the status, the place that we find ourselves, even consider continuing?

That might draw a huge cry. It's intended to. It's intended to maybe shock some people and say, well, how are we going to do better? What should we do better? And if you have a performance standard and you tell me that you're going to be looking into this, who's not performing? Where are the loans?

Suppose you've got 2 or 3 or 10 mortgage brokers who are out there peddling these things and just don't care simply because they're just getting their cream. Then the thing goes up for sale and the same house is resold over and over and over, or the same kind of person is brought into the system who will never have a chance of repaying. What a terrible thing that would be for the other people, plus the taxpayers. It will jeopardize the entire program.

So that's where I'd like to see us go, and I think we've got to get all the facts out and take a look at them. I guess politicians and economists will always be misunderstood. So I hope that I wasn't too terribly misunderstood.

Eco 101 was a tough class for me, anyway. [Laughter.]

I want to thank you all for coming, for testifying, and I look forward to reviewing your report. We'll probably have some more questions for you in the future.

We stand in recess.

Mr. WADDELL. Thank you, Senator.

[Whereupon, at 1:07 p.m., the subcommittee was recessed.]



**An Actuarial Review of the
Federal Housing
Administration's Mutual
Mortgage Insurance Fund**

June 6, 1990

Price Waterhouse

**Office of Government Services
1801 K Street, N.W.
Washington, D.C. 20006
(202) 296-0800**

Price Waterhouse



June 6, 1990

The Honorable Jack Kemp
Secretary of Housing and Urban Development
Washington, D.C. 20410

Dear Mr. Secretary:

We are pleased to present this report on our review of the soundness of FHA's Mutual Mortgage Insurance Fund. Our analysis finds that the Fund is currently solvent due to a large surplus that was inherited from the 1970's. However, we believe that continuation of present policies will eventually lead to insolvency because new business written under existing policies is unsound.

We recommend that the MMI Fund change its policies so that it attains a capital to insurance-in-force ratio of 1.25 percent. To meet this goal, FHA needs to increase its value by about \$1.35 billion relative to its financial position today.

Our report identifies alternative policies that will improve new business such that it will provide additional capital consistent with this target. These policies include:

- o Increase the premium from 3.8 percent to 6.0 percent.
- o Require a minimum downpayment of 11 percent of home price, premium, and closing costs.
- o Restructure the premium to a 1.6 percent up-front premium and 0.5 percent annually through the term of the mortgage.
- o Charge all borrowers the current 3.8 percent up-front premium and require an additional 0.5 percent annual premium to high LTV borrowers. The annual premium would be charged for the following periods:

The Honorable Jack Kemp
June 6, 1990
Page Two



<u>Initial LTV</u>	<u>Years</u>
0 - 90%	0
90 - 93%	4
93 - 95%	10
> 95%	15

These policies were designed to ensure that future business meets the proposed capital standard and allows continued payment of distributive shares. Smaller premium increases or lower downpayment requirements would be sufficient to meet the proposed capital standard if distributive share payments were suspended.

Our analysis is dependent to some degree on the quality of data provided to us by FHA and the forecasts of economic conditions available from various organizations. The analysis was conducted using economic models that are by their nature subject to some degree of error and may not exactly predict future behavior. These limitations are addressed in the technical appendices.

This report was prepared with the assistance of Mr. Samuel Gutterman, FSA, an actuary employed by Price Waterhouse, and Dr. Patric Hendershott of Ohio State University. If you have any questions about this report, please call Mr. Thomas Craren or Mr. James Waddell at (202) 296-0800.

Very truly yours,

Price Waterhouse



Table of Contents

<u>Section</u>	<u>Page</u>
Executive Summary	1
I. Introduction	4
II. Past Performance of the Fund	10
III. Future Performance of the Existing Business	23
IV. FHA Policy Options	36



List of Exhibits

<u>Exhibit</u>	<u>Page</u>
ES-1 Impact of the 1980's Business on the Estimated 1989 Economic Value of the MMI Fund	3
II-1 Comparison of Conditional Claim Rates to Growth in the Constant Quality House Price Index	11
II-2 Sensitivity of Claim Rates to Loan-to-Value Ratio, 1975-85 Endorsement Years	12
II-3 Sensitivity of Claim Rates to Loan Size, 1975-85 Endorsement Years	13
II-4 Sensitivity of Prepayment to Mortgage Interest Rates	14
II-5 Loss Rate by Termination Year	15
II-6 Loan Endorsements by Endorsement Year	16
II-7 Composition of MMI Fund Portfolio	16
II-8 Distribution of Loan Endorsements by Loan-to-Value	17
II-9 FHA Loan-to-Value Calculation	19
II-10 Composition of Insurance-in-Force Across HUD Regions	20
II-11 HUD Regions	21
II-12 Constant Quality House Price Appreciation Across Regions of the U.S.	21
II-13 Unamortized Insurance-in-Force for the Ten Largest States	22



<u>Exhibit</u>	<u>Page</u>
III-1 Current and Projected Present Value of Endorsement Years 1975 - 1989	27
III-2 Sensitivity of Existing Insurance-in-Force to House Price Appreciation and Variation	28
III-3 Sensitivity of Existing Fund to Loss Ratio	29
III-4 Ultimate Claim Rates under Consensus Economics	29
III-5 Economic Value under Alternative Economic Conditions	31
III-6 Historical and Forecasted Changes in Constant Quality House Prices	33
III-7 Historical and Forecast Loss Rates	33
IV-1 Sensitivity of New Business to House Price Appreciation and Variation	37
IV-2 Sensitivity of Policies to House Price Appreciation	45

Executive Summary

This report evaluates the soundness of the Federal Housing Administration's Mutual Mortgage Insurance (MMI) Fund. The soundness of the Fund is a concern due to the magnitude of losses that FHA has recently reported. Indeed, declining house price appreciation, a major recession, and severe stress in the "oil-patch" states have caused substantial losses through the 1980's. Combine this with past poor management practices and lax monitoring, and one is left with a Fund that may not survive even moderately poor conditions, much less a major economic problem. The lessons learned from the 1980's are important. No longer can (or should) FHA rely on inflation or rapid house appreciation to save mortgages that are poorly underwritten, improperly monitored, and excessively risky.

This study was undertaken to learn why MMI suffered these large losses, to assess the likelihood of MMI suffering more losses from its 1980's business, and to determine whether the combination of recent losses and anticipated future losses have rendered MMI fundamentally unsound. The value of business currently being written is estimated, and policy options to strengthen the Fund are considered.

Any analysis of the MMI Fund must recognize that FHA's public purpose can be, and often is, at odds with its statutory requirement to be sound. But taking on risks that the revenue of the Fund simply cannot support will eventually lead to the Fund's reliance on the Treasury or on budget appropriations to sustain its operations. While reliance on the Treasury to cover catastrophic conditions might be appropriate in the most severe circumstances, we believe that, given current statutory requirements, MMI must (at a minimum) maintain enough equity to withstand, on its own, moderately severe economic conditions.

In order to evaluate the soundness of the Fund, we developed detailed statistical models that quantify the effect of loan characteristics and economic factors on defaults and prepayments. Default is explained primarily by the equity position of the borrower, which depends on the initial downpayment of the borrower and changes in house prices and, to some extent, interest rates after purchase. Prepayments are determined to a large extent by changes in interest rates.

The economic climate that underlies our analysis was derived from projections by the National Association of Realtors, the Mortgage Bankers Association, the Congressional Budget Office (CBO), and the Office of Management and Budget (OMB). These organizations publish forecasts of interest rates, house price inflation rates, and unemployment rates, although CBO and OMB publish consumer price rather than house price inflation rates. Because all of these forecasts were in a narrow range, we refer to the baseline forecast as the "consensus" economic scenario.

Based on our analysis of defaults, prepayments, and MMI's financial position, we have concluded the following:

- The Fund is currently solvent under consensus economics. That is, the Fund will have a positive value if it writes no new business and uses its current resources to pay claims expected to occur over the life of the existing loans.
- The portfolio of insurance-in-force has a positive value only because it had developed a substantial equity position from the business written before 1980. As of the

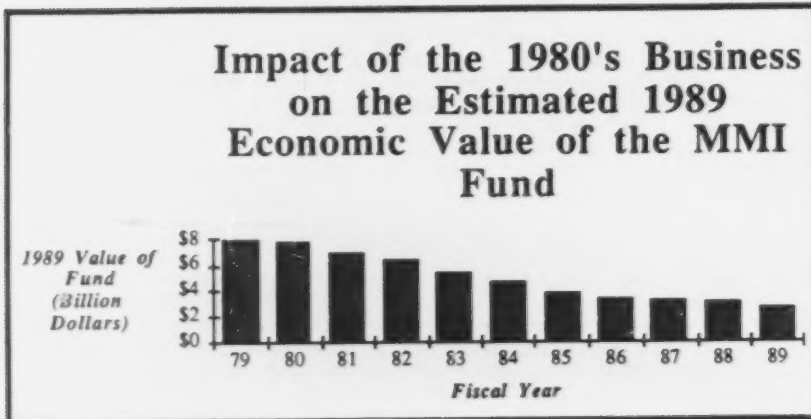
beginning of the 1980's, business already insured by MMI had an economic value of \$3.4 billion. This represented 5.3 percent of unamortized insurance-in-force. Invested at one-year Treasury rates, this value would have grown to \$8.0 billion by the end of the 1980's. However, this potential value has been eroded to about \$2.6 billion in 1989 (see Exhibit ES-1) or only one percent of unamortized insurance-in-force.

- There is no single standard of actuarial soundness. We have derived guidelines for MMI's soundness based on the need to withstand adverse conditions. These guidelines require MMI to have positive economic value even if adverse economic conditions develop. The capital required to meet this test, with some margin for error, is \$3.75 billion or 1.25 percent of insurance-in-force. Current economic value of \$2.6 billion is short of this requirement. That is, the MMI Fund is not currently sound.
- The MMI Fund is currently paying distributive shares on pre-1989 business (primarily relating to years 1979 and prior). The present value of these expected future payments is \$1.3 billion. To the extent payment of distributive shares is continued, terms on new business will have to be tightened further in order to cover the payments and continue to build equity at the 1.25 percent level.
- The business written each year is unsound. Under the consensus economic scenario, the 1990 business is expected to have a value of negative \$208 million. Under a less favorable -- but reasonably possible -- scenario the business will have a value of negative \$667 million. Business written beyond 1990 of similar size and risk composition will also face losses.
- It is crucial that new business be put on a sound footing as soon as possible. To comply with the above guideline and suspension of distributive shares, the present value of new business each year must improve by about \$625 million. If distributive shares are continued, another \$135 million will be needed. This both offsets the \$208 million loss and allows equity to build by 1.25 percent of the net additional business (\$48 billion new insurance less \$15 billion estimated terminations). Alternative policies that would approximately achieve this result including the payment of distributive shares are:
 - Increase the premium from 3.8 percent to 6.0 percent
 - Require a 11 percent downpayment on the house price, premium, and closing costs
 - Restructure the premium to be 1.60 percent up-front and 0.5 percent annually through the term of the mortgage.
 - Charge the 3.8 percent up-front premium to all borrowers and an additional annual premium of 0.5 percent based on the riskiness of the loan. Loans with FHA-defined LTVs less than 90% would pay no additional premium, loans with LTVs between 90% and 93% would pay the annual premium for four years, LTVs between 93% and 95% would pay the annual premium for ten years, and LTVs greater than 95% would pay the annual premium for fifteen years.

MMI FUND ANALYSIS

- Management reforms could significantly reduce the losses on the disposition of properties. Such reforms could both improve the soundness of the existing Fund and could lead to lower premiums on new MMI business. Their implementation should receive high priority at FHA.

EXHIBIT ES-1



Note: This exhibit illustrates the estimated economic value of the portfolio as of the end of the year indicated, plus interest earned between that year and 1989. This exhibit excludes the effect of distributive shares.

I. INTRODUCTION

A. Background and Purpose of this Study

FHA's mission is to expand homeownership opportunities. FHA's MMI Fund plays a major role in this endeavor by insuring low-downpayment mortgages on single-family homes, thus making credit available to individuals who would otherwise have difficulty obtaining it. However, in addition to providing better access to mortgage credit, MMI must by statute be operated in accord with sound actuarial and accounting practices. Balancing the need to expand homeownership with the requirement to do so in a sound manner can be difficult, particularly if economic conditions and the credit risk MMI accepts combine to cause substantial losses. Moreover, the substantial losses suffered by other Federal credit programs, including those now apparent in other FHA programs, make it essential to understand why and how the MMI Fund incurs losses, in order to provide a basis from which corrective measures can be taken.

The MMI Fund has recently begun to report losses of increasing magnitude. While some have contended that these losses primarily resulted from a simple change in accounting policies, in fact the losses resulted from a real deterioration in the Fund's operations. For example, a review of the insurance written by MMI from 1980 through 1985 reveals that premiums collected for this insurance are not even sufficient to cover claims paid to date, much less provide equity to cover future losses. When premiums collected for a particular year's business are not sufficient to cover resultant losses, equity built up from more successful years is eroded. If insurance written between 1986 and 1989 also loses money, as we estimate it will, then the financial viability of the MMI Fund becomes a paramount concern.

Any institution or entity seeking to be "sound" should have capital or, in FHA's case, equity sufficient to protect against adverse risks. Charging a fee that covers outflows only in an optimistic or even expected scenario does nothing to build a cushion against the possibility that operating conditions may worsen. Adverse risks can range from cyclical economic downturns, to structural changes in the markets served, to fraud. The relative strength of many financial institutions in the private sector is judged, and indeed the cost of their capital is determined, by their ability to withstand such adverse risks. While the MMI Fund is unique and not wholly comparable to a private sector counterpart, the need to provide a cushion -- at least against a reasonably poor economic scenario -- is fundamental to actuarial soundness.

Finding the right size of the cushion given the MMI Fund's implicit public purpose presents a particular challenge. Too little equity risks making MMI reliant on the Treasury (and ultimately the taxpayer) in even moderately adverse conditions. Moreover, Federal credit reform proposals currently being considered by Congress and the Administration would probably require appropriations in the event that the MMI Fund's equity were to go negative. If the equity target is set too high, the resulting high premiums may make ownership unaffordable and potentially exclude those individuals most in need of the services FHA was meant to provide. An objective of this study is to provide guidelines under which the MMI Fund can restore its eroding equity to protect against a reasonable degree of adverse risk. At the same time, equity consistent with these guidelines will not be adequate under catastrophic conditions. Therefore, the policy options and observations in this study assume that under catastrophic conditions MMI must rely on the backing of the Federal government.

B. Scope of the Study

Our approach to this study was to 1) find the present position of the MMI Fund -- claims paid in relation to premiums collected -- for each year or "book" of business currently in force, 2) construct and estimate an econometric model to identify the factors causing claims and prepayments, 3) use the model and assumptions regarding future economic conditions to predict future claims and prepayments, and 4) translate these predictions into an estimate of the current economic value of each year's book of business. We estimated the Fund's economic value as an investor would evaluate the market value of a company, as the net present value of its future cash flows. These flows include premium receipts, claim payments, proceeds from property sales, premium refunds (when mortgages are prepaid), and administrative expenses. We then analyze how the economic value of the Fund would change as economic conditions change. A similar analysis is applied to the business the MMI is currently writing, and the sensitivity of the economic value of this new business to alternative constraints on the risks taken by MMI and premiums charged is computed.

In our evaluation, the value of MMI Fund depends on a number of factors, most notably:

- *The nature of the risk FHA insures. Among the more important considerations is the mix of the insurance by loan-to-value ratio, and particularly, whether insurance is becoming concentrated in higher loan-to-value loans -- those loans with very low downpayments.*
- *Forecasts of the economic factors that have a significant impact on the financial position of the MMI Fund. Of great importance here are those factors that create homeowner equity -- most particularly house price appreciation.*
- *Historical relationships. This analysis involves correlating historical claim and prepayment experience to business and economic conditions. It is also necessary to determine how relevant historical experience is to the future performance of the Fund.*
- *FHA Management efficiency. Historically, FHA has recovered about 63 percent of the claim amount when it sells an insured property. Improvements in this 37 percent loss rate -- through quicker sales of property, at higher prices -- would significantly increase the value of the Fund.*

Based on this analysis of the MMI Fund value, we then identify the approximate value that the Fund should currently maintain so that it will not become negative during adverse economic scenarios. Finally, we developed policy reforms that, if adopted by FHA, would enable the Fund to achieve the prescribed level of capital for its new business.

C. What is Actuarial Soundness?

The term "Actuarial Soundness" has taken on an increasingly important meaning as the MMI Fund has begun to face substantial losses. Yet neither housing legislation nor internal or external studies of FHA have adequately defined the term. Further, the actuarial profession cautions against the use of this and other ill-defined terms.

MMI FUND ANALYSIS

An internal study conducted by HUD staff in 1975 defined actuarial soundness as a situation wherein "premium income should be expected to cover expected administrative expenses and the benefits provided to lenders in the case of foreclosures." We believe this definition is inadequate. Sound actuarial practices would require that premium income be sufficient to provide protection against potentially adverse circumstances, such as economic downturns.

In the legislation pertaining to the Federal Housing Administration and its Mutual Mortgage Insurance Fund, the phrase "sound actuarial and accounting practice" first appeared in 1938 in the old Section 205(b) of the National Housing Act. Later the same phrase was used as a guide to the internal allocation of income and losses between the two components of MMI's equity that were legislatively created in 1954: the General Surplus Account and Participating Reserve Account. Finally, when the one-time premium was established by the Omnibus Budget Reconciliation Act of 1982, the premium was required to be "actuarially sound". Despite the use of these terms in the legislation, they have come to be collectively known simply as "actuarial soundness" with no attempt to define what that term means either qualitatively or quantitatively. Later, when MMI is compared to private mortgages insurance companies (MICs), we note that state regulatory authorities have developed detailed quantitative criteria under which MICs must operate.

Given the confusion surrounding the term and how it might be applied to MMI, we recommend that more specific requirements be developed. These specific requirements are stated in section III. The general principles reflected in these requirements are consistent with accepted actuarial practice. In our view, "actuarial soundness" implies more than simply providing for the current best-estimate of future experience. Although the FHA is a federal agency, we do not believe that it is appropriate to rely on Treasury bail-outs for the Fund unless experience develops that is significantly more adverse than is currently expected. These beliefs are based on the following:

- The commitments the Fund has undertaken are long-term in nature, with guarantees up to 30 years in duration. Thus, to determine adequate funding levels, it is necessary to reflect more than just the current cash position. Equity, or the value of the Fund, taking into account the present value of expected future cash flows for the current in-force business, is the appropriate measure on which to focus attention.
- Future economic conditions affecting the financial position of the Fund will not precisely correspond to currently estimated consensus economic conditions. A significant degree of uncertainty will always exist concerning such conditions.
- Sound actuarial practices require that a financial security program with such a degree of uncertainty be funded on a reasonably conservative basis. Therefore, it is sound actuarial and accounting practice to provide for experience somewhat more adverse than currently expected. Given the type of contingencies involved, we believe that the most reasonable approach is to determine the ability of the Fund to operate in a soundly based manner under a range of reasonably probable alternative economic conditions.
- It takes a reasonably long period of time, from two to six years, to determine whether structural changes in the economic system in which the Fund operates have occurred that would adversely impact the finances of the Fund. We are hopeful that improved monitoring and analytical capability will be in place in order to measure such experience. However, it still takes a considerable amount of time to interpret and communicate the implications of adverse experience.

- In addition, it may take a considerable amount of time to "fix" the situation once adverse conditions are recognized. Certain changes may require Congressional action, while many others require the development of a significant degree of consensus. While catastrophic conditions would likely result in relatively quick action, the more likely scenario of relatively moderate adverse conditions may take several years before changes to the program are possible.

The conclusion that the Fund should provide for more than our best estimate of future losses is consistent with the current discussion draft of the Society of Actuaries' Committee on Actuarial Principles, dated March 1990, that states:

Principle 4.5: The actuarial value of a financial security system relative to a given actuarial model is the combined actuarial value of the net cash flows generated by the assets, obligations and considerations of the system, taking account of the uncertainty involved in the risk variables and the process of combining them.

Principle 4.6: The best-estimate actuarial value of a financial security system must be made greater than zero in order for the system to be actuarially sound (paraphrased as: "Due to experience fluctuations, surplus and margins are needed to make a financial security system actuarially sound.")

On the other hand, the value of the Fund need not be sufficient to withstand all conceivable future economic conditions. We do not believe it is possible to build MMI's equity to a level needed to cover catastrophic risk. To do so would require premiums at levels that would impair MMI's social purposes. Catastrophic risk is implicitly covered through the backing of the U.S. Treasury.

An effective way to establish an easily understandable guideline -- one similar to those established by state insurance regulators -- would be to define equity requirements as a percentage of insurance-in-force. The percentage required can and should be designed to provide enough equity to cover a reasonably adverse, but not catastrophic, economic situation. Section III provides our recommendations on appropriate guidelines for establishing this percentage.

In proposing these new requirements, we wish to emphasize that analysis of experience and the level and structure of the premium should be a dynamic exercise. Ultimately FHA must have the ability to formulate and implement corrective actions quickly.

D. Comparison to Private Mortgage Insurance Companies

Having briefly discussed some aspects of MMI Fund operations, it is useful to compare MMI operations and operating requirements to those of Mortgage Insurance Companies (MICs). In this manner we can make some observations about aspects of private mortgage insurance that might prove useful to FHA.

The real estate boom of the 1920's led to the significant expansion of mortgage guarantee companies that had existed in some form since the 1890's. During their peak years (1925-1932), as many as 50 of these companies were in operation. The prevailing viewpoint during this period was that real estate values would continue to appreciate, and if any lax

underwriting or appraising occurred, the resulting questionable mortgage would be saved by inflation. Due to the general optimism about the economy and the lack of attention by the government, these mortgage guaranty companies were virtually unregulated. The absence of regulation often led to poor underwriting, self-dealing, fraud, and ultimately to a lack of adequate reserves to meet any meaningful emergency. The collapse of real estate prices resulting from the Great Depression led to the failure of these companies. Private mortgage insurance did not reappear for almost 25 years.

When MICs did reappear in the 1950's, they were accompanied by strong regulatory control. This regulatory control entailed more than just a broad requirement that MICs be "actuarially sound". Rather, State Regulatory authorities developed specific requirements under which MICs must operate. Today these requirements address not only levels of capital required for the aggregate amount of risk taken by a particular insurer, but also terms and conditions for risk taken on individual transactions.

The specific regulations vary among the states but generally provide that a MIC can insure one- to four-family mortgage loans that do not exceed 95 percent of the fair market value. Before a MIC can begin insuring loans, it must meet minimum limits for paid-in capital and surplus. Its insurance exposure is limited to 25 times the value of the capital -- that is, capital must be four percent of insurance exposure. Furthermore, MICs can generally only insure 20-25 percent of the mortgage in contrast to the MMI Fund, which insures 100% of the mortgage.

Three types of reserves must be maintained by MICs:

- **Unearned Premium Reserve.** Premiums received but as yet unearned are placed in this reserve. Further, depending on the length of the policy, the manner in which unearned premiums are recognized as income is established by regulation. The MMI Fund similarly has an unearned premium reserve since the entire premium for most of its insurance is collected at closing.
- **Loss Reserve.** This reserve is established for losses or potential losses on a case-by-case basis as the company learns of defaults and foreclosures. It also includes a reserve for losses that have been incurred, but not yet reported to the company. In 1987, the MMI Fund began for the first time to record loss reserves for defaults from which claims were likely to result.
- **Contingency Reserve.** This is a special reserve required by law to protect against the type of catastrophic loss that can occur in severe economic periods. Half of each premium dollar received goes into this reserve and cannot be used by a MIC for 10 years, unless losses in a calendar year exceed 35 percent of earned premiums and the insurance commissioner of the state where the insurer is domiciled concurs in the withdrawal. Normally this reserve is a component of capital for financial reporting purposes. The MMI Fund has no such reserve, nor any requirement that a portion of its premium be set aside for losses that could occur during a severe economic period. The MMI Fund's "general surplus" account is roughly analogous to a contingency reserve, although there is no statutory or regulatory requirement as to the levels at which this equity must be maintained.

E. How the MMI Fund Differs from MICs

The MMI and MICs have many similarities. Both protect lenders against losses from defaults by borrowers and both serve to expand the supply of capital flowing to single-family housing. But there are also many differences that are important to highlight. These differences can be summarized as follows:

- **Premium structure.** Currently, the MMI Fund's premium for a 30-year conventional mortgage is 3.8 percent of the initial loan. This one-time premium is collected up-front and in the majority of cases is financed. Further, the premium percentage does not vary based on the initial LTV, i.e., it is the same regardless of the percentage downpayment. MICs typically charge a yearly premium that is higher in the first year, and the premium rates are larger for borrowers making smaller downpayments. Further, MICs do not allow financing of the premium they charge.
- **Degree of Coverage.** MICs generally insure about 20% of the mortgage amount, while FHA insures 100%. Because MICs insure a smaller amount of the mortgage, they often utilize an optional claim settlement, whereby the insured portion of the defaulted mortgage is paid, relieving the MIC of the responsibility for disposing of foreclosed property. By contrast, MMI pays the full claim amount and then in most cases takes possession of the foreclosed property. It is then responsible for selling the property, a costly and time-consuming process.
- **Loan-to-value ratios.** MICs cannot insure mortgages with loan-to-value ratios greater than 95%. FHA often insures mortgages with initial loan-to-value ratios greater than 95%. In fact, FHA often insures mortgages with loan-to-value ratios that are greater than 100%, if FHA were to calculate loan-to-value in a manner similar to MICs. Later in the report, we illustrate the differences in the way the loan-to-value ratio is calculated by FHA as opposed to MICs.

Several observations can be made about these differences. First, FHA's lack of differential premium pricing will tend to undercharge borrowers who make only a small downpayment (who tend to default more often) and overcharge those with larger downpayments. Thus, if FHA were to raise premiums across the board, it may find that less risky borrowers who make higher downpayments will opt for conventional loans. This could mean that FHA will increasingly insure only more risky borrowers, for whom claim rates would be greater. This principle of adverse selection poses serious risks for the Fund. As FHA becomes less attractive for less risky borrowers, the remaining borrowers will face still higher premiums if the Fund is to attain a sound position.

Second, since MICs insure only about 20% of the mortgage and do so only for loans with downpayments of 5% or more, FHA's loss exposure is much higher. FHA's risk is exacerbated by the fact that its true loan-to-value ratio often exceeds 100% for low downpayment borrowers. However, the difference between the 20% per loan risk taken by MICs versus the 100% per loan risk taken by FHA also renders use of the MICs 4% capital-to-risk requirement less meaningful to FHA.

Third, the fact that FHA finances virtually the entire premium means that little is collected from borrowers who default.

II. PAST PERFORMANCE OF THE FUND

In theory, the borrower's decision to default is based primarily on the equity position of the property relative to the value of the mortgage. It is necessary to analyze the past performance of the Fund to test this proposition. This analysis would determine whether historical factors directly affecting buyer equity explain past defaults. Such factors include the amount of the downpayment and house price appreciation. More specifically we consider the following:

- The correlation between claim rates and economic factors: For example, how did changes in interest rates and house price appreciation affect claim rates? And how are claim rates affected by regional stress?
- Loan-to-value ratios: What is the correlation between lower downpayments and defaults?

For factors shown to affect defaults, we will then consider how they might be used to help predict the portfolio's future performance.

A. Historical Performance of FHA-Insured Mortgage Loans since 1961

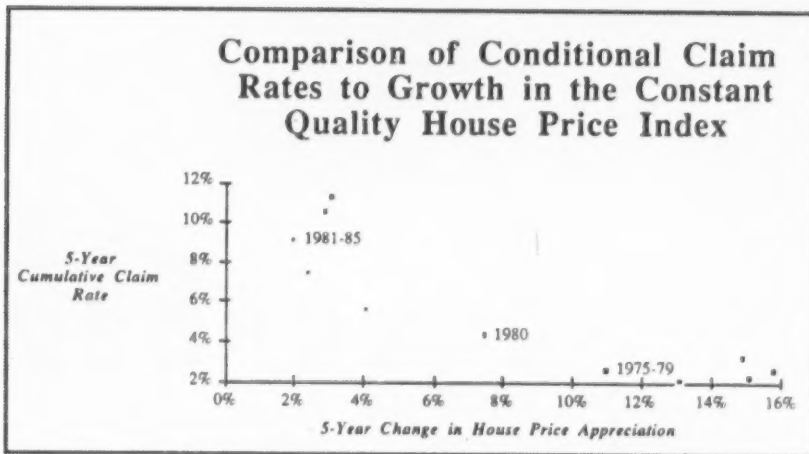
In evaluating the past performance of the MMI Fund there are three fundamental factors that affect its financial position: (1) claim rates, (2) prepayment rates, and (3) loss rates. Analyzing the factors that affect these historical rates will help provide a basis for projecting future rates. Our approach was to identify the economic factors and loan characteristics that have influenced default, prepayment, and losses during the 1975 through 1989 period. The analysis was conducted using econometric models. These models are described in Appendix A. In this section, we illustrate the general relationships of these variables to economic conditions and loan characteristics using historical averages.

1. Claims

The late 1960's and most of the 1970's was a period of comparatively high inflation and a consistent rise in house prices. Claim rates for the MMI Fund were very low during this period, despite FHA's low downpayment requirements, and the Fund reported substantial excesses of premium revenue over claim cost and expenses. Prior to 1980, house price appreciation was high and claim rates relatively low. Since 1980, house prices have increased less than 3 percent per year and default rates have risen significantly.

Exhibit II-1 presents a comparison between the average annual rate of house price appreciation and cumulative claim rates over a five-year period. The exhibit shows a striking inverse relationship between the house price appreciation rate and defaults. During the late 1970's rapidly rising house prices resulted in low default rates. Defaults surged during the 1980's as house price appreciation slowed.

EXHIBIT II-1

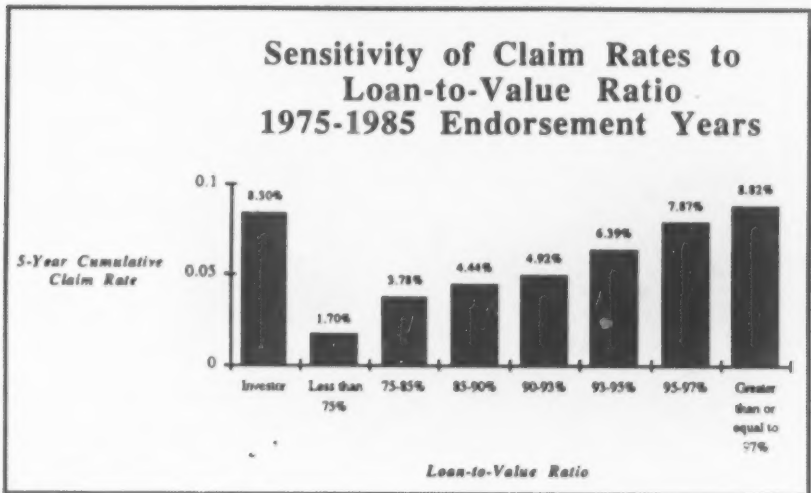


Source: House price appreciation: U.S. Department of Commerce,
Bureau of the Census
Claim rates: FHA's A-43 Database

These trends demonstrate a relationship found in most studies of default: default is most likely to occur when a borrower has a negative equity position in the property -- normally because the value of the property has fallen below the loan balance. Some contend that default is caused by factors beyond the borrower's control, such as illness, divorce, or unemployment. While it is recognized that such life changes may provoke a default, borrowers in these circumstances are likely to sell their homes rather than default if their equity position is positive.

The borrower's equity position is determined by a variety of factors, but most significantly by the initial loan-to-value ratio and subsequent house price appreciation. Exhibit II-2 illustrates how claim rates for the first five years of a mortgage have varied by loan-to-value (LTV) category during the 1975 - 1985 period. The chart clearly shows that higher downpayments (lower LTVs) result in lower default rates. In fact, borrowers with an initial downpayment of 3 percent or less had a claim rate more than five times higher than the rate for those with more than 25 percent down. The FHA experience indicates that homeowners have higher likelihood of default and foreclosure as the LTV increases with the effect accelerating when the LTV moves above 90 percent. Conversely, borrowers with low LTVs, and thus a significant equity investment at the time of the loan origination, are much less likely to "walk away" from the mortgage.

EXHIBIT II-2



The historical effects of LTV and house price appreciation on defaults are consistent with the view that equity plays a major role in explaining defaults. Other factors that were found to have a statistically significant influence on default included:

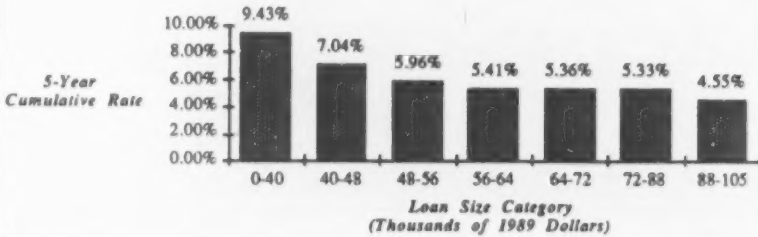
- House price variation
- Loan size

While house price appreciation obviously has an important role in defaults, not all borrowers are affected by the same national average changes in house prices. To incorporate regional variations in prices, we also considered the variation of house prices across geographic regions. Intuitively, if there is a significant variation among regions, some locations must have much lower increases than the national average thus making borrowers in those regions more likely to default. During the 1980's, for example, house prices in the South (especially Texas) rose much more slowly than in other areas, resulting in higher defaults in that region. Measuring the variation of house prices among regions for modelling purposes, then, captures the effect of regional stress on aggregate default.

Exhibit II-3 demonstrates the sensitivity of claim rates to loan size. Within the FHA portfolio, higher valued loans tend to have a lower probability of default. Most of this effect is captured by the higher default rates in the \$0 - \$40,000 and \$40,000 - \$48,000 categories. For loans above \$48,000, the effect is minimal and is not statistically significant. Data from the private mortgage insurers seem to indicate that default rates above the FHA ceiling are relatively constant, although they increase substantially at about \$180,000.

EXHIBIT II-3

**Sensitivity of Claim Rates
to Loan Size Category
1975-1985 Endorsement Year
Loans**

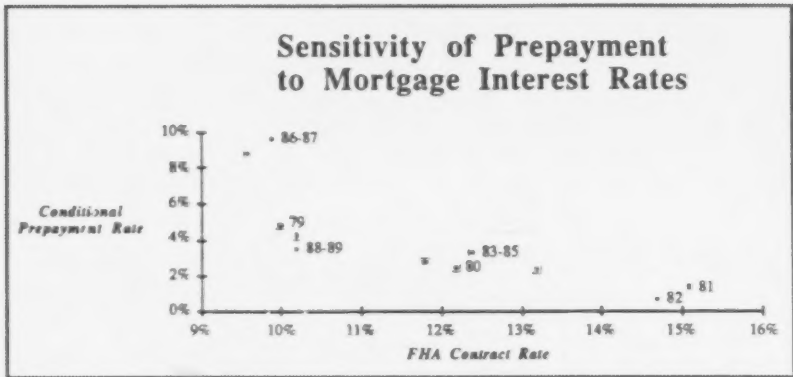


2. Prepayments

A prepayment causes an outflow of cash from FHA as the unearned portion of the up-front premium is refunded to the borrower. On the other hand, prepayment eliminates the possibility of a claim. Given these offsetting effects, prepayments are not as significant in the performance of the Fund as claims.

Borrowers prepay their mortgages either because they plan to sell the property or because they want to refinance their mortgages. Prepayments are influenced by interest rates, as refinancing activity usually follows a reduction in interest rates. Exhibit II-4 demonstrates that periods of lower interest rates are associated with higher prepayment rates. Borrowers holding mortgages with interest rates above the current market rate will find it advantageous to prepay and refinance with new mortgage terms. Conversely, increasing interest rates discourage prepayment, because homeowners will perceive that their existing mortgage is relatively less costly than a new mortgage.

EXHIBIT II-4

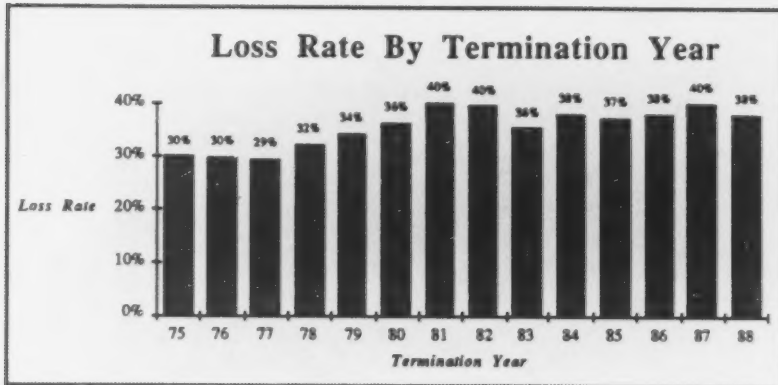


3. Loss Ratio

The loss ratio indicates the percentage of a claim payment FHA will lose because proceeds from the sale of an acquired property will be insufficient to recover the payment. One might expect that lower LTV loans might have lower loss rates. However, while a borrower with an initial downpayment of 10 percent is less likely to default than a borrower who put 5 percent down, the loss rates are similar when either defaults. The 90 percent borrower is likely to hold on to a property longer simply because he has a larger equity cushion; but if he defaults, it is unlikely that there will be more value left at the time of default.

Perhaps of greater interest is the variation of loss rates over time. Loss rates have been generally higher during the 1980's than during the 1970's, although they vary considerably as shown in Exhibit II-5. In our analysis, we have used a 37 percent loss ratio for future claims. This is a somewhat favorable figure compared to the experience of the 1980's. Our more adverse scenario uses a 40 percent value. This is the highest figure recorded in the last decade, and it occurred three times during the period.

EXHIBIT II-5



B. Trends In Characteristics of FHA-Insured Loans

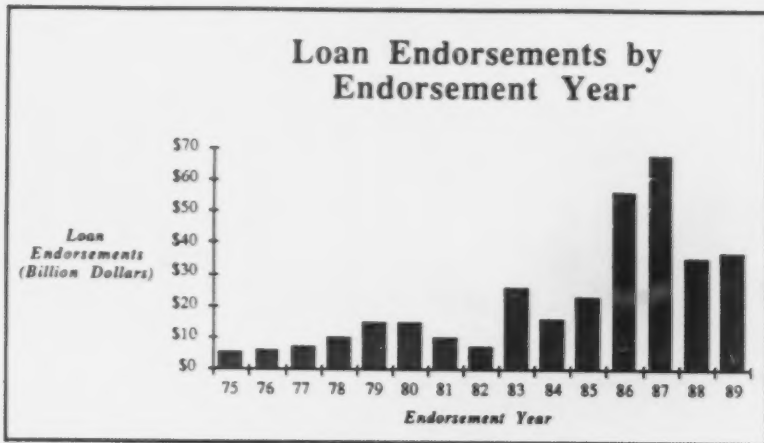
We previously described some of the significant factors that affect mortgage defaults, prepayments, and loss ratios. In particular, certain categories of loans were shown to have higher risks than other categories. In this section, we examine trends in the FHA portfolio to determine whether FHA's credit risk has shifted in recent years.

The composition of the FHA's insured loan portfolio under MMI has changed significantly over time. Changes have occurred in the total volume of loan demand, the regional variation in loan demand, and the distribution of loans across the range of FHA-allowed LTV ratios. An overview of some of the trends in the characteristics of the portfolio are provided below.

1. Trends in Demand for FHA-Insured Loans

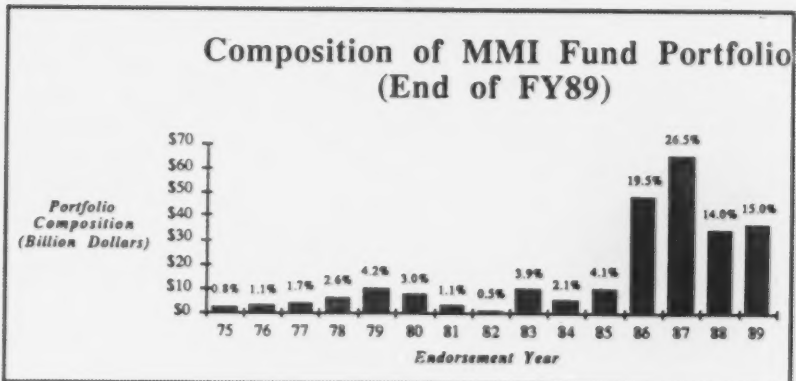
Exhibit II-6 illustrates that the volume of FHA loan origination grew dramatically since 1975, from \$4.6 billion to a high of \$67.5 billion in 1987. Economic factors in the late 1980's, such as falling interest rates, combined with a growing economy, contributed to the increase in demand. This demand weakened somewhat in 1988 and 1989 as interest rates increased.

EXHIBIT II-6



The increase in loan origination in the late 1980's has had a significant impact on the distribution of originating mortgages and insurance-in-force. The dollar value of mortgages that were insured in 1987 and currently survive exceeds the dollar value of surviving mortgages from endorsement years 1975 through 1985 combined, as illustrated in Exhibit II-7.

EXHIBIT II-7



MMI FUND ANALYSIS

2. Changes in Loan-To-Value Ratio and Loan Size Distribution

The distribution of loan originations across the LTV categories has fluctuated over the 1980's. This fluctuation is illustrated in Exhibit II-8. Since 1986 loan demand at the high LTV levels, especially in the 95-97 LTV category, has increased. The proportion of investor loans increased significantly in the 1980 to 1984 period, but has fallen recently and in 1990 virtually all investors are excluded from FHA's MMI programs. Even though participation of investors has fallen recently, somewhat reducing risk, the proportion of high loan-to-value loans in 1988-89 has risen. Overall, investor loans and business above 95 percent LTV comprised about 51 percent of the MMI Fund's 1988-89 endorsements, versus 35-45 percent in earlier years. Because these loans are so much riskier than those below 95 percent LTV (see Exhibit II-2), the 1988-89 business is riskier than the 1980-87 business.

EXHIBIT II-8

DISTRIBUTION OF LOAN ENDORSEMENTS BY
LOAN-TO-VALUE

LTV Category	1980-81	1982-83	1984-85	1986-87	1988-89
Below 75%	8.7%	15.6%	10.9%	11.6%	5.6%
75 - 85%	8.6%	12.9%	7.7%	10.9%	5.4%
85 - 90%	10.9%	11.8%	10.5%	10.7%	10.0%
90 - 93%	10.5%	10.8%	10.6%	10.0%	11.6%
93 - 95%	16.2%	14.1%	13.6%	12.4%	16.5%
95 - 97%	28.9%	18.8%	22.8%	26.0%	36.7%
97 % and Above	3.2%	1.7%	4.8%	3.9%	7.0%
Investors	12.9%	14.4%	19.1%	14.6%	7.3%

An additional factor explaining changes in loan size and LTV is the change in FHA policy regarding loan-to-value. The following table summarizes these changes:

MMI FUND ANALYSIS

Increases in FHA Loan-to-Value Maximum since 1971**December 1971:**

97% of the first	\$15,000
90% of the next	\$10,000
80% of the remainder	

September 1974:

97% of the first	\$25,000
90% of the next	\$10,000
80% of the remainder	

November 1977:

97% of the first	\$25,000
95% of the next	\$10,000
80% of the remainder	

July 1980:

97% of the first	\$25,000
95% of the remainder	

May 1985:

97 % if appraised value is \$50,000 or less	
Otherwise, 97% of the first \$25,000, 95% of the remainder	

The changes in loan-to-value requirements in 1980 and again in 1985 were significant in that they increased the number of loans with higher risk, thus increasing default risk in the MMI Fund. Another significant change that went into effect on September 1, 1983 was the introduction of the one-time premium collected at closing. Borrowers were allowed to finance the entire premium, but this additional level of financing was excluded from the loan-to-value calculation. The premium was, in effect, paid as the mortgage amortized.

The loan-to-value ratios calculated by FHA significantly understate the true LTV. Based on the downpayment requirements just described, one would expect the LTV ratio not to exceed 97%. However, when closing costs and the financed premium are considered, the actual loan-to-value ratio can easily exceed 100%, as illustrated in Exhibit II-9. The fact that some of the FHA mortgage insurance premium is refundable acts as a partial offset to the borrower's ability to finance the insurance premium.

EXHIBIT II-9

FHA LOAN-TO-VALUE CALCULATION

	<u>FHA</u>	<u>Private Insurer</u>
Selling Price	\$75,000	\$75,000
Allowable Closing Costs (1)	<u>2,250</u>	
Maximum Allowable	77,250	75,000
Downpayment (2)	<u>3,363</u>	<u>3,750</u>
Maximum Mortgage Amount Before MIP	73,888	71,250
MIP Financed (3)	<u>2,808</u>	<u>0</u>
Total financed	<u>\$76,695</u>	<u>\$71,250</u>
FHA calculation of Loan-to-Value (4)	95.6%	
Actual Loan-to-Value (5)	102.3%	95%

- (1) Assumed to be 3% of selling price.
- (2) FHA downpayment equals 3% of the first \$25,000 and 5% of the remainder (\$77,250 - 25,000 * 5%); private insurers' minimum downpayment requirements are 5% of the selling price by state regulation.
- (3) Mortgage Insurance Premium (MIP) is 3.8% of the maximum mortgage amount before MIP.
- (4) FHA loan-to-value is the maximum mortgage amount before MIP divided by "maximum allowable" amount.
- (5) Actual loan-to-value is the total amount financed divided by the selling price.
- (6) Cash required for the privately insured loan includes the downpayment, closing costs, and, in many cases, an up-front insurance fee. Together these payments make the amount of cash required up-front substantially larger for privately insured loans than for FHA-insured loans.

3. Geographic Distribution of FHA Insurance

The distribution of insurance-in-force across HUD regions has shifted over time, as shown below in Exhibit II-10. Regions that have experienced above average growth in loan demand include Great Lakes, South Central, Midwest, Mountain, the Mid Atlantic, and the Northwest. The percentage of mortgages in force in the North Atlantic and the Southwest fell slightly, while that of the Northeast and Southeast were relatively stable overall. The Southwest continues to be the dominant region, with more than one fifth of the total insurance-in-force, while the Northeast and the Midwest continue to have a very small percentage of the total insurance-in-force. Exhibit II-11 defines the HUD regions.

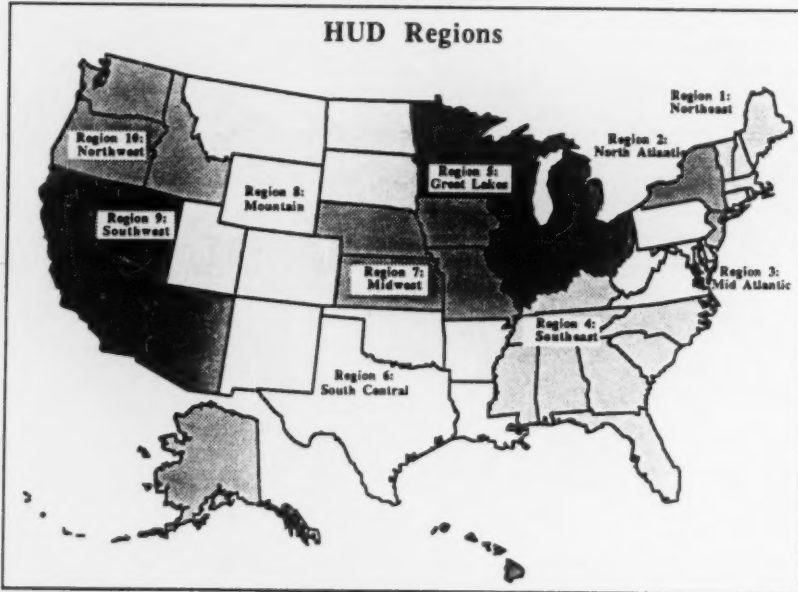
EXHIBIT II-10

COMPOSITION OF INSURANCE-IN-FORCE ACROSS HUD REGIONS

		1980	1984	1989
1.	Northeast	0.77%	1.23%	0.51%
2.	North Atlantic	9.29%	8.20%	4.89%
3.	Mid Atlantic	6.09%	9.43%	10.27%
4.	Southeast	18.50%	15.85%	17.48%
5.	Great Lakes	12.27%	13.52%	14.45%
6.	South Central	13.38%	14.45%	14.59%
7.	Midwest	2.83%	3.09%	3.43%
8.	Mountain	7.43%	8.12%	8.23%
9.	Southwest	25.32%	22.21%	20.99%
10.	Northwest	4.05%	3.86%	5.15%

EXHIBIT II-11

HUD Regions



Geographical distribution is significant because regional economies can vary widely and have a significant impact on claim rates. From 1964 to 1989, the average national house price appreciation rate has fluctuated between 2.7% and 12% annually. Exhibit II-12 shows that regional house price appreciation varies widely from national trends. For example, the Northeast experienced considerably higher appreciation than the rest of the country during the 1960's and 1980's; during the 1970's, the West had the greatest appreciation.

EXHIBIT II-12

CONSTANT QUALITY HOUSE PRICE APPRECIATION
ACROSS REGIONS OF THE US

	National	Northeast	Midwest	South	West
1964-70	4.0%	7.2%	5.0%	3.4%	2.8%
1970-76	8.2%	7.4%	7.9%	7.9%	9.6%
1976-81	12.0%	10.5%	10.8%	11.5%	14.2%
1981-89	2.7%	8.6%	3.0%	1.8%	2.2%

Source: U.S. Department of Commerce, Bureau of the Census

MMI FUND ANALYSIS

The significance of the variations in regional economics just illustrated means that the Fund can incur losses even with favorable national trends. Moreover, if a particular region has an economic downturn (like that seen in the "oil states"), then losses can result even in a favorable national economic climate. Thus, a model of future performance must consider adverse regional variations from national trends.

Losses can also result if there are economic problems in a particular state and MMI has a disproportionately large share of its business in that state. To highlight the areas of risk, Exhibit II-13 shows insurance-in-force in the top ten states.

EXHIBIT II-13

UNAMORTIZED INSURANCE-IN-FORCE FOR THE TEN LARGEST STATES (Origination Years 1975-1989)			
Rank	State	Amount of Insurance-in-force (\$ Billions)	Percent of Total
1	California	\$39.73	16.2%
2	Texas	\$27.35	11.2%
3	Florida	\$15.32	6.3%
4	Colorado	\$14.12	5.8%
5	Arizona	\$13.62	5.6%
6	Minnesota	\$12.79	5.2%
7	Maryland	\$11.49	4.7%
8	Virginia	\$10.56	4.3%
9	Illinois	\$9.96	4.1%
10	Washington	\$9.08	3.7%
	All others	<u>\$80.89</u>	<u>33.0%</u>
Total		\$244.91	100.0%

Note that FHA still has high amounts of insurance-in-force in two states that have had heavy recent losses -- Texas and Colorado. Another added concern is the impact actions by the Resolution Trust Corporation (RTC) could have on FHA. For example, if the RTC has a large inventory of single-family properties in one or more of these states, their subsequent sale may depress the price FHA receives when it sells its foreclosed properties, thus increasing the loss rate. Depressed prices may also lead to higher default rates.

III. Future Performance of the Existing Fund

Having reviewed the past performance of the MMI Fund, we now assess the ability of the MMI Fund to withstand future losses emanating from the current portfolio. In particular, we focus on the sufficiency of the Fund's equity if unfavorable economic conditions occur. Finally, we develop guidelines for the Fund's soundness and evaluate the current position of the Fund against these guidelines.

A. Approach to the Analysis

In analyzing the financial viability of the MMI Fund, we developed econometric models to project operations and cash flows resulting from default and prepayment behavior under various economic conditions. A "base case" scenario was developed to assess whether the MMI Fund is sound under conditions that are reasonably expected to occur. We also tested the MMI Fund's ability to withstand an adverse -- but probable -- economic scenario. Below we discuss the economic and financial models used and the tests applied. A summary of findings concludes this section.

1. Summary of Methodology

The behavioral assumptions in our models view borrowers as making decisions about their mortgage obligations so as to optimize their wealth. Mortgage holders in servicing their mortgage obligations have three basic options: 1) pay as scheduled, 2) prepay the entire principal amount, or 3) default. The decision to exercise any one of these options will be made based primarily on the equity position in the property relative to the value of the mortgage. Distinctions are made for the borrowers' decisions when modeling defaults and prepayments.

- **Default Model** - The default model is specified to estimate directly conditional probabilities of default and in turn claim terminations for selected categories of borrowers. These categories relate to the loan-to-value (LTV) position of the borrower. The variable most significant in explaining defaults is the borrower's equity position. The equity position in the home will be determined by the initial LTV, the extent of price appreciation in the property, the market value of the mortgage, amortization of the loan (years from origination), and transaction costs associated with default. By estimating equity appreciation over time for properties financed by different classes of mortgages, the model directly estimates conditional default probabilities and the volume of defaults for a portfolio of mortgages.
- **Prepayment Model** - The prepayment model incorporates a similar model specification to estimate the number of prepayments for specified categories of initial loan size and LTV. Prepayment behavior is expected to be sensitive to downward movements in interest rates as rational borrowers will refinance a mortgage following a significant reduction in the prevailing mortgage interest rate. Changes in interest rates will alter the perceived mortgage value to the borrower measured as the discounted value of the future stream of payments. The conditional probability of prepayment is specified as a function of the borrower's valuation of the mortgage liability such that a fall

(increase) in interest rates will increase (decrease) the mortgage liability and increase (decrease) the prepayment probability.

The analysis separates 30-year and 15-year mortgages. Graduated Payment Mortgages (GPMs) comprise a small portion of the MMI portfolio and were analyzed by comparing their historic claim rates to those of fixed-rate mortgages. The models are then used to simulate and forecast numbers of defaults and prepayments under specified economic conditions. To forecast defaults, it is necessary to posit the average equity appreciation and regional dispersion of property values about the mean. The number of defaults and prepayments are computed from the estimated probability of default or prepayment. Prepayment forecasts require projections of interest rates.

2. Assumptions Underlying the Analysis

Our evaluation of the future performance of the existing insurance-in-force incorporated a base economic forecast to project the claim and prepayment rates and the resulting cash flows of the Fund through the term of all existing loans. This economic forecast is derived from the forecasts of several organizations and includes projections for overall house price appreciation, variability of house price appreciation, mortgage interest rates, and unemployment rates. Because loan performance is sensitive to fluctuations in the economic climate, alternative scenarios were also established and tested.

a. Consensus Economic Climate

The baseline economic climate is established from a review of near-term forecasts published by the National Association of Realtors (NAR), the Mortgage Banker's Association of America (MBAA), the Office of Management and Budget (OMB), and the Congressional Budget Office (CBO). The key assumptions for consensus economic trends for the period from 1990 through 2018 are:

House Price Appreciation	4.5%
Mortgage Interest Rates	10.0%
Unemployment Rates	5.5%

These forecasts reflect an average economic climate for the future based on published economic forecasts. Below are the published economic projections and the 1989 values:

MMI FUND ANALYSIS

	Median House Price Appreciation	Mortgage Interest Rates	Unemployment Rates
NAR	4.6%	9.8%	5.4%
MBAA	4.5%	9.7%	5.6%
OMB	3.0 - 4.0% *	7.0 - 10.0%	5.0 - 5.4%
CBO	4.3% *	8.8 - 9.5%	5.5%
Actual (1989 rate)	4.5%	10.3%	5.3%

*These are CPI forecasts; no house price forecast is available.

The measure of house price appreciation that is reported by NAR and MBAA is the rate of change in median sales price. This index thus reflects the price of houses actually sold. Because new houses tend to be larger over time and to have more amenities (such as central air conditioning and more bathrooms) and existing houses are occasionally renovated, median sales prices will increase faster than prices for insured houses.

The Constant-Quality House Price Index is published by the Bureau of the Census. It is designed to measure changes over time in sales prices of single-family houses that are the same with respect to ten important physical characteristics as the houses sold in 1982. This index excludes price increases that result from improvements in house quality. As a result, this index provides a better measure of changes in the price that a current owner could receive for his house. The relevant consideration for an individual is how much his house value has changed since purchase, not how the average value of a generally rising quality house stock has changed. In translating median house price appreciation into constant-quality appreciation, two percent was deducted from the annual median house price appreciation, based on historical averages.

Our analysis is concerned with the performance of loans over an extended period, while most published forecasts are for two to five years. In all cases, the near-term projections are extended to the end of the forecast horizon (30 years). While this may not reflect the views of the published reports, extending these forecasts represents a plausible economic climate. In any case, the near-term economic climate will have a more significant impact on the Fund because most defaults take place in the first ten years of the mortgage.

b. Assumptions for Non-economic Factors used in the Analysis

Three other key non-economic assumptions are made. The FHA loss ratio on disposed properties is assumed to be 37 percent. This represents the average expected loss on

MMI FUND ANALYSIS

property disposition as a percentage of the claim payout on FHA acquired properties. Future changes in the loss ratio will be tied largely to management policy. To evaluate the impact and the uncertainty of future loss ratios on the Fund alternative scenarios have been developed using loss ratios of 35 percent and 40 percent.

The two other assumptions built into our model pertain to the timing between default and claim settlement and the time required for FHA to dispose of acquired properties. It is assumed that claim settlement will occur on average 15 months following initial default on the mortgage. Further, FHA is expected to be able to dispose of properties eight months after acquiring the property through claim settlement. These values are averages of recent experience.

B. Results Under Consensus Economic Climate

In the consensus economic environment, constant quality house prices are assumed to increase by 3.25 percent. Under this assumption, it is projected that the current value of the MMI Fund is \$2.6 billion. This \$2.6 billion value reflects the current cash available to the Fund, plus the present value of periodic premium receipts and receipts from property disposal, less the present value of claim payments, premium refunds, and administrative expenses. This valuation is greater than the GAAP accounting net equity position recorded at the end of fiscal year 1988 by \$755 million. GAAP accounting does not allow recording future revenues until they are realized. However, any deficiency must be recorded as soon as it can be estimated.

This estimate of economic value is prepared by first analyzing the current cash position of all loans originated since 1975, by year of origination. The cash generated to date, for each year of business, reflects the historical experience of the business and is not dependent on the model. The left-hand side of Exhibit III-1 shows that the financial position of each year of business written from 1980 - 1985 is already negative. While the years 1986 - 1988 would appear to be in a strong positive cash position, this is because the up-front premium has been collected but insufficient time has passed to observe many claims.

MMI FUND ANALYSIS

EXHIBIT III-1

Current and Projected Present Value of
Endorsement Years 1975 - 1989

Endorsement Year	End of FY88		Ultimate	
	Cumulative Claim Rate	Cash Reserves (Millions)	Cumulative Claim Rate	Cash Reserves (Millions)
1975	3.89%	\$206	4.48%	\$240
1976	3.66%	236	4.35%	283
1977	2.86%	358	3.91%	429
1978	3.69%	417	5.88%	521
1979	5.99%	299	10.03%	434
1980	9.96%	(315)	14.65%	(241)
1981	16.02%	(828)	19.41%	(801)
1982	16.26%	(646)	18.84%	(628)
1983	9.18%	(941)	14.61%	(886)
1984	11.05%	(618)	17.86%	(791)
1985	7.47%	(526)	15.34%	(874)
1986	2.10%	1,168	10.98%	(379)
1987	0.37%	2,358	10.78%	(186)
1988	0.01%	1,292	12.76%	(294)
1989	--	--	12.72%	(283)
Total		\$2,458		(\$3,454)

For each year of business, we then project claim and prepayment experience to the term of the mortgages endorsed in each year and compute the present value of the business based on these projections. These computations are shown in the last two columns of Exhibit III-1. For some years prior to 1984, future results are expected to improve the value of the business because future premium receipts are expected to exceed losses associated with claims. The value of business written with up-front premiums (since 1984) already reflects all premiums that will be received. Thus, it can only deteriorate from its current position.

The net result of this analysis is that 1975 - 1989 business has contributed \$2,458 million in cash reserves to the existing Fund, but has an ultimate value of negative \$3,454 million. Business written before 1975 contributes a positive \$131 million to the present value of the Fund, because of additional collections of periodic premiums. As a result, we expect the Fund's cash reserves to deteriorate \$5.8 billion in present value terms from their current levels through the term of the loans. Somewhat more than this amount has been provided for in the financial statements, through the unearned premium (\$3.9 billion) and loss reserves (\$2.7 billion). The difference between the reserves (positive \$6.6 billion) and the present value of cash outflows (\$5.8 billion) represents the expected increase in the economic value of the Fund. When added to the previous accounting equity position (\$1.8 billion), we estimate the economic value of the current portfolio, including all cash reserves, to be about

\$2.6 billion. This estimate, however, is subject to downward revision based on the policy of distributive share payments, discussed below.

In view of the uncertainty regarding the future economic climate, sensitivity tests are presented about this consensus economic forecast. Exhibit III-2 shows the impact of varying these economic assumptions. When the constant quality house price appreciation rate varies between 1.25 percent and 6.25 percent per annum the economic value of the Fund is projected to range between \$1.0 billion and \$4.0 billion. The combination of greater regional price variation and low house price appreciation is sufficient to push the value of the Fund below zero.

EXHIBIT III-2

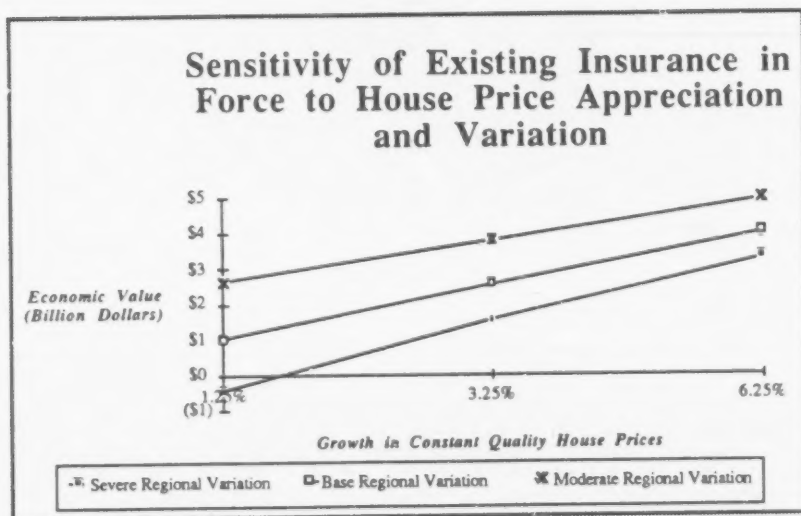
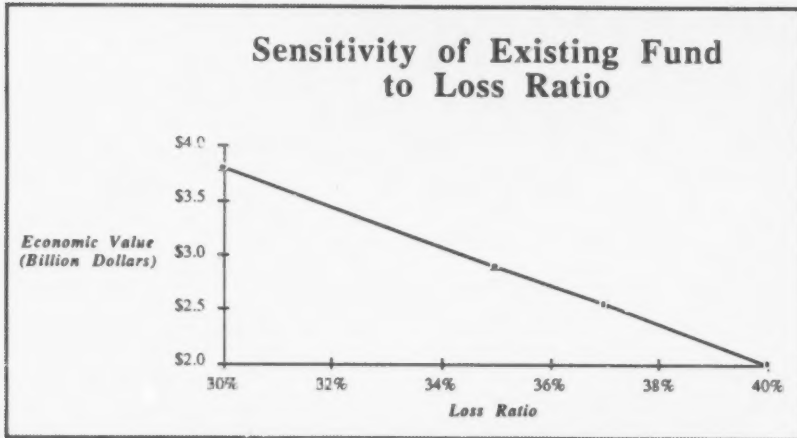


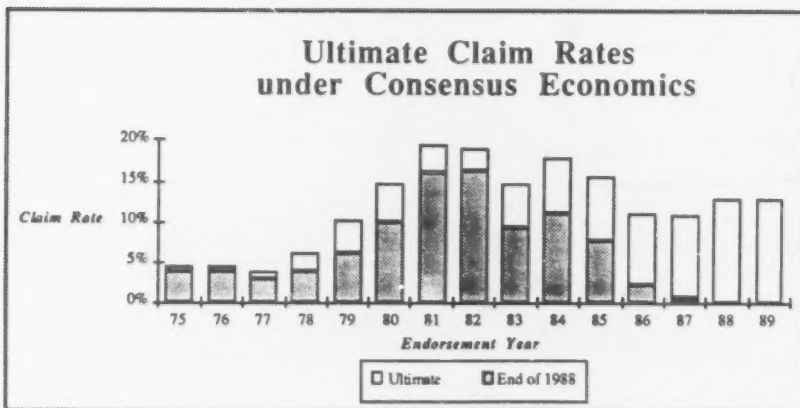
Exhibit III-3 shows the impact of alternative assumptions for the loss ratio. Increasing the loss ratio to 40 percent will reduce the projected value of the Fund to \$2.0 billion, while lowering the loss ratio to 30 percent, the value recorded in the middle seventies, would raise the Fund value to \$3.8 billion.

EXHIBIT III-3



In applying the consensus economic forecast, the ultimate claim rate on the 1980's insured loans will rise significantly above the experience of the prior years. Exhibit III-4 shows that loans originating after 1985 will have an ultimate claim rate of 11 - 13 percent. While this represents a significant drop from the early 1980's, our analysis indicates that the level of expected claim terminations will ultimately result in a net outflow of cash for each endorsement year. Further, this portion of the FHA-insured loans represents about 75 percent of the current insurance-in-force.

EXHIBIT III-4



The relatively low claims so far recorded against the 1987 through 1989 business have lead some to conclude that the generally lower claim rates of the 1970's may be a more appropriate indicator of claim rates for 1987 through 1989 endorsements. This view overlooks the fact that the 1970's business benefitted from the higher inflationary environment of the late seventies and early eighties. We do not expect this environment to recur. The policies of the Administration and the Federal Reserve Board are consistent with a low inflationary environment. For this reason, the relatively low early claim rates for the 1987 - 1989 business are not inconsistent with the ultimate claim rates that are projected.

C. Major Economic Changes

One approach to assessing the soundness of the MMI Fund is to follow the methodology employed by bond rating agencies. In the process of developing bond ratings, agencies assess the adequacy of the capital (equity) buffer between bondholders and the bankruptcy courts. The capital buffer is necessarily viewed in light of risks specific to the company/industry being reviewed. Thus, when agencies develop a bond rating, they also implicitly assess the capital adequacy of a firm.

Because FHA is essentially an insurer of mortgages, the credit rating approach reflects this methodology for issuing bond ratings for private mortgage insurers. This methodology is applied through a stress test using a most detrimental scenario to determine how long an insurer (FHA) would survive a Great Depression scenario. This scenario includes four consecutive years of 10 percent nominal declines in house prices, a rise in the unemployment rate to 20 percent, and 5 percentage point declines in interest rates. In our model, both the rise in unemployment and the decline in house value trigger sharply greater default. In fact, we estimate that the economic value of the existing business would fall to -\$17.2 billion. As noted above, we assume that the social purpose of the Fund is such that it should not be expected to withstand such a calamity.

To evaluate the impact of lesser economic swings on the financial position of the Fund, two economic cycles were tested. The first is an extended period of rising interest rates coupled with rising inflation and house price appreciation followed by a period that reverses this trend. Such an economic climate would be comparable to the late 1970's and early 1980's. Ironically, economic conditions of this type that may be detrimental to the well-being of the macro economy are favorable to the mortgage insurers, including FHA. Rising inflation builds equity into the property and reduces the real mortgage debt obligation, thus reducing incentives to default on the properties.

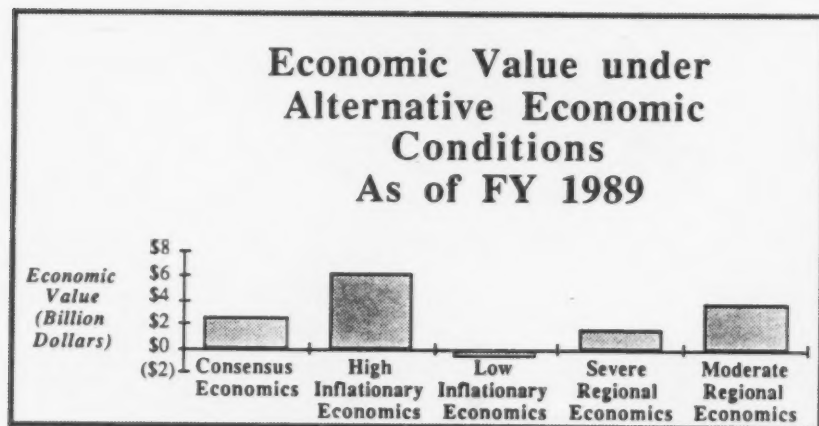
The second cycle incorporates a period of low house price appreciation and interest rates and then an increase to today's levels. Such a period is expected to have a considerably adverse effect on the financial position of the Fund. Low house price appreciation will require a longer period in which the homeowner needs to build equity in the home sufficient to deter mortgage default. More specifically the cycles are:

MMI FUND ANALYSIS

	Low Inflation			High Inflation		
	House Price Appreciation	Mortgage Rate	Unemployment Rate	House Price Appreciation	Mortgage Rate	Unemployment Rate
1990-96	4.0-1.0%	9.5-6.5%	6.0%	6.0-14.0%	11.5-19.5%	5.0-7.0%
1997-04	1.0-4.0%	6.5-9.5%	6.0-5.5%	12.0-4.0%	17.5-9.5%	5.5-10.0%

Exhibit III-5 shows the economic value of the Fund under these two cycles in comparison to the earlier computed values for the consensus economics base case and the moderate and severe house price variation cases. As can be seen, the high inflation cycle would raise the value to \$6.1 billion, while the low inflation cycle could reduce the value to -\$0.7 billion.

EXHIBIT III-5



D. Recommendations for the Continued Soundness of the MMI Fund

We recommend that the MMI Fund have sufficient equity to survive an economic scenario that is more adverse than the base case. How large equity must be depends on how risky the insurance terms are (e.g., maximum loan-to-value ratio) and how adverse the scenario is.

The appropriate level of surplus, then, is the sum of two amounts:

- The loss of value of the current portfolio if adverse economic conditions occur. For purposes of our analysis, the current portfolio is defined to be the insurance-in-force at the end of fiscal year 1989.

- The value under adverse conditions of additional business written before current policies are changed. We assume, optimistically, that changes can be made during the current fiscal year. Thus, the value of the Fund must also be sufficient to offset the losses associated with adverse economics on an additional year of business, which in our analysis was taken to be 1990.

In conducting this analysis, we considered two adverse scenarios. The first is a downward revision of our baseline economics. The second is a moderate recession that is generally consistent with post-1951 recessions, although not as substantial as the cycles in the 1980's.

The downward revision scenario is somewhat less favorable than the consensus economics, but has a reasonable probability of occurring. The downward revision is:

- House price appreciation rates at 2.5 percent per year instead of 3.25 percent.
- House price dispersion rates calculated as the average of the 1975-89 rates and the 1980-89 rates. In contrast, the baseline dispersion rates are 90 percent of the 1980-89 rates, reflecting less price dispersion.
- Loss ratio at 40 percent, rather than 37 percent as in the baseline scenario.

These changes are assumed to persist throughout the term of the mortgages.

We emphasize that all of these components are not only possible but have occurred in the last ten years. Specifically, the downward revision assumes an average increase in constant quality house prices of 2.5 percent per year; the 1985 - 1989 average was 2.0 percent. The house price dispersion rates used in the downward revision are more favorable than the 1980's experience. The loss ratio of 40 percent used in this adverse scenario occurred three times in the 1980's. Exhibits III-6 and III-7 display the adverse house price appreciation and loss rates relative to their historical and baseline values.

EXHIBIT III-6

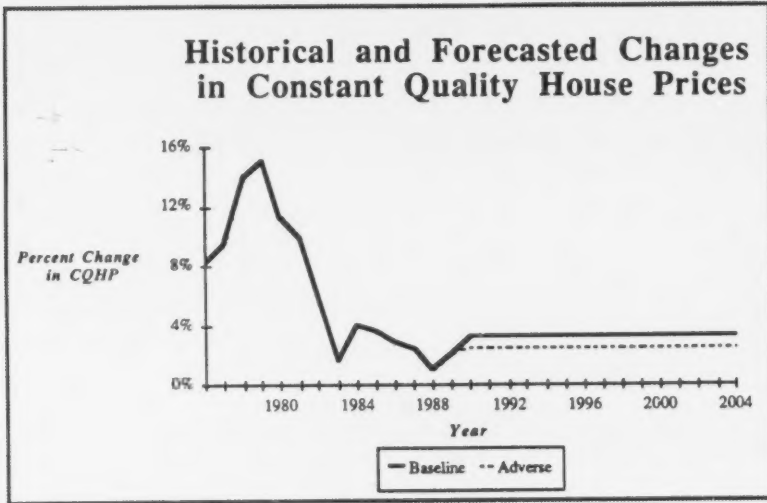
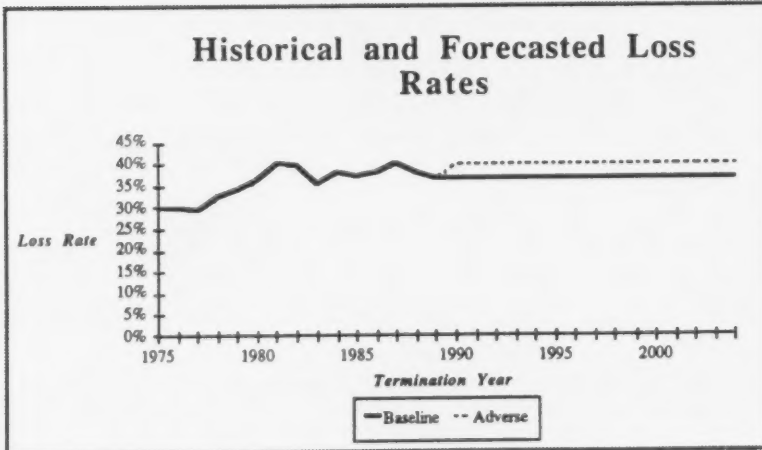


EXHIBIT III-7



Under the adverse economic conditions, the Fund's estimated value declines by \$2.35 billion relative to the value estimated under consensus economics. Adverse economics will reduce the value of the 1990 business from -\$208 million to -\$667 million. This suggests that the Fund should have a value of \$3.0 billion today, in order to remain solvent under this adverse scenario. This value is derived as the loss of value in the portfolio (\$2.35 billion) plus the loss of value on the 1990 insurance (\$0.67 billion).

The second scenario is what we term a moderate recession. In this we assume the following changes relative to the base case:

- Lower house price appreciation by 2 percentage points
- Lower interest rates by 1.5 percentage points
- Higher unemployment rates by 3 percentage points

These changes occur over two years and are phased out by the fifth year. At that time, the values return to the baseline economic scenario.

Under this recession scenario, the Fund's existing portfolio declines in value by \$2.1 billion and the new business has a value of -\$876 million. That is, the result is very similar to the adverse scenario in that market-value capital of \$3.0 billion is required.

Based on this analysis of two potential adverse scenarios, the Fund should have an economic value of about \$3.0 billion. At the end of fiscal year 1990, there will be roughly \$300 billion insurance-in-force. Thus, the required ratio of capital to unamortized insurance could be set at one percent. However, our basic model slightly underpredicts defaults, and the response of default to the economic variables is estimated with some uncertainty. To be conservative, we allow for a 25 percent cushion in the \$3.0 billion and set a capital standard of 1.25 percent of insurance-in-force. With \$300 billion insurance-in-force, this translates into required economic capital of \$3.75 billion. As of the end of fiscal year 1990, the Fund is expected to have an economic value of \$2.4 billion, which is \$1.35 billion short of the minimum 1.25 percent capital ratio.

The 1.25 percent is not a desired ratio, but a minimum ratio. As we saw in the 1980's, when the capital ratio declined from 5.3 percent to one percent, far more than 1.25 percent capital could be needed.

The market value of the Fund is based on the net present value of all future inflows and outflows expected to result from the current portfolio. Book value differs somewhat because GAAP precludes current recognition of future inflows. Today, book value is only about 75 percent of market value (\$1.8 / \$2.4). Thus, GAAP-equity of one percent of unamortized insurance-in-force is currently equivalent to an economic value of about 1.25 percent of insurance-in-force.

We would recommend, however, that this guideline be reviewed over time to reflect changing economic conditions. For example, if policies are changed and adverse conditions do not develop, equity in the Fund will build over time relative to amortized insurance-in-force. On the other hand, an even worse economic scenario could develop. Either event would call for a reassessment of the MMI insurance terms.

MMI FUND ANALYSIS

Similarly, future changes in the Fund portfolio or economic conditions will cause changes in the relationship between book value and market value. While market value is a better measure of the Fund's ability to withstand changes in the economic climate, book value is a more widely reported value and is based on the financial statements. For these reasons, the relationship between market and book value should be monitored periodically.

E. Present Position

In order to be in a long-term sound financial position, the Fund requires a value of \$3.75 billion, compared to its current economic value of \$2.4 billion. That is, even without the payment of distributive shares, the Fund is substantially short.

Of equal concern is that additional business written by the Fund has a value of -\$208 million under consensus economics. That is, new business is likely to erode equity rather than building it as desired. In the next section, we examine policies that enable FHA to meet the capital adequacy standards on the new business.

IV. FHA Policy Options for Insuring New Mortgages

In the previous two sections we recommended that the MMI Fund maintain equity equal to 1.25 percent of insurance-in-force. In this section we present various policy options designed to allow new business to add economic value equal to 1.25 percent of insurance written. We also indicate policies that will both do this and allow payment of distributive shares.

These policy options are suggested in light of the following:

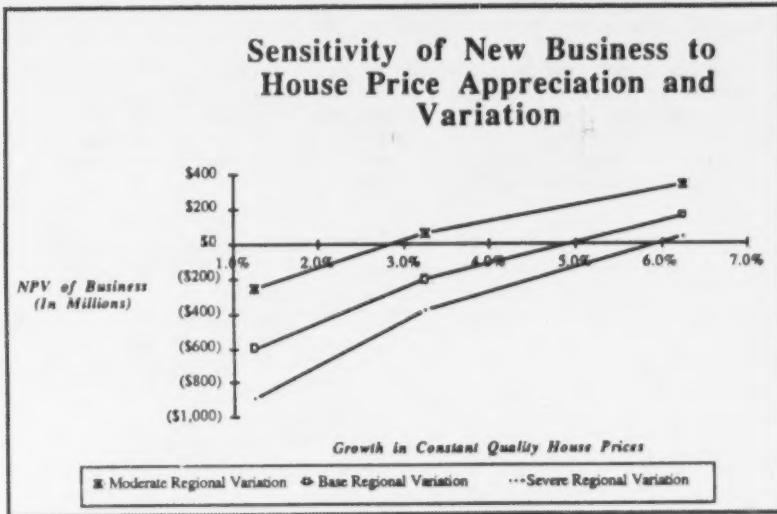
- *Under consensus economic conditions, each additional year of new business will reduce the value of the Fund by about \$200 million if current policies are maintained.*
- *Reasonably possible, but adverse, economic scenarios would result in the Fund's economic value quickly becoming negative.*

A. Current Conditions

We estimated the value to the Fund of FHA's 1990 business under existing terms and conditions. This analysis was based on consensus economic conditions and a distribution of business by loan size and loan-to-value that is similar to the business written in 1989. Under these assumptions, we estimate that 11.6 percent of loans insured by FHA in 1990 will default at some time during their lives. This business has a present economic value to FHA of -\$208 million. In other words, loans insured during 1990 under current policies are expected to reduce the value of the Fund by \$208 million.

Like our earlier results, this figure is sensitive to the assumptions made about the economic climate over the next 30 years. Exhibit IV-1 shows the expected results under alternative house price appreciation and regional variation assumptions. While the exact values vary depending on the nature of the economy, the expected value of the 1990 business is negative under most reasonable assumptions. The 1990 business will break even only if constant quality house prices increase at the rate of about 4.6 percent per year for a thirty-year period. This seems unlikely since the constant quality house price inflation rate since 1981 has averaged 2.7 percent and has been only 2.1 percent since 1985.

EXHIBIT IV-1



B. Alternative Policies Affecting the Terms and Conditions of Insurance

In order to avoid insolvency, the terms of FHA insurance must be revised. Based on our previous analysis, the policy options needed to strengthen the Fund are fairly straightforward and can be categorized as follows:

- Raise the premium
- Restructure the premium
- Raise the minimum downpayment
- Reduce the losses experienced when a property defaults

The last policy is affected by management practices and state laws requiring waiting periods between default and foreclosure. Although there is substantial room for improvement in management practices and reduction in losses per property, we have not assumed that considerable changes will occur. We have assumed a loss ratio of 37 percent which represents a slight improvement over the loss ratio of the most recent years. Exhibit II-5, which showed that the loss ratio remained high throughout the 1980's, does not provide an historical basis for assuming strong improvements in the loss ratio. This, coupled with the potential impact of RTC property sales, cautions against optimistic property sale assumptions as a basis for improving the MMI Fund's equity position. Further, such improvements are

MMI FUND ANALYSIS

normally slow to implement and difficult to achieve. As a result, it is prudent to focus on the terms and conditions of insurance than have a more direct and measurable effect on the Fund's financial soundness.

The following chart summarizes the various policy measures to achieve two different goals under consensus economics: (1) build equity equal to 1.25 percent of the net new business added (\$48 billion written less \$15 billion terminated), and (2) build this equity and earn sufficient revenue to continue paying distributive shares. Building equity necessitates a \$625 million improvement in value (to \$415 million) and building equity and paying distributive share requires a \$760 million increase (to \$550 million).

	Build Equity	Build Equity & Pay Distributive Shares
1) Raise Premium to:	5.6%	6.0%
2) Raise Required Downpayment to:	10%	11%
3) Restructure the Premium to an Up-front / annual premium	1.35% up-front 0.5% annually for the mortgage life	1.6% up-front 0.5% annually for the mortgage life
4) Charge 3.8% up-front to all borrowers and 0.5% annual premium for a varying length depending on the initial LTV:		
0-90%	0 years	0 years
90-93%	4 years	4 years
93-95%	7 years	10 years
> 95%	11 years	15 years

These policy measures will enable the Fund to build equity to 1.25 percent on new business. They will not, however, enable the Fund to meet the capital requirements on existing business. To do so, these policy options would have to be even stronger. For instance, MMI might consider charging a premium that would enable FHA to build equity on new business and pay distributive shares but use the distributive share capital to build equity on the existing business. In this manner, the Fund would reach its capital requirements slowly over time. Charging the higher premium -- whether it is used to pay distributive shares or to build equity for the existing book -- places the burden of correcting the errors of the 1980's on the new business.

The policies examined tend to raise the cash required by borrowers and/or eliminate certain categories of very risky loans. In some cases, potential homebuyers may have to wait longer to purchase a home due to the increased cash needed at closing. When measures require purchasers to put up more cash, we anticipate that purchasers who would otherwise have borrowed less than the maximum amount will increase their loan to provide the additional cash. Our calculations reflect this behavioral response.

Following is a discussion of each policy scenario.

Policy Scenario 1 -- Raise the Premium

One obvious method to improve the financial position of new business is simply to increase the insurance premium. If the premium can be raised high enough to offset expected losses, the business can be made profitable. Increasing the premium would also temporarily increase Federal budget receipts.

Advantages:

- Administratively simple -- charging a higher premium does not involve many internal operation charges.
- Requires only a minimal increase in household up-front cash contribution.

Disadvantages:

- Because the premium can be financed, an increase in the premium reduces the quality of the business written. Mortgagors are assumed to borrow the additional premium amount and increase their "true" loan-to-value ratios. The premium must be raised even higher to offset the additional default risk.
- FHA will become somewhat less competitive with the private mortgage insurers. Adverse selection should be anticipated as lower risk borrowers might be able to obtain better terms from private insurers. The greater risk encountered at higher premium levels is exacerbated by FHA's policy of charging one premium to all borrowers, regardless of risk. The private insurers offer lower premiums for better quality loans and may be more attractive to FHA's lower risk borrowers. Because we have not built adverse selection into our calculation, the premium should be increased by greater amounts than we have indicated.

Under this policy option, the premium required to break-even assuming distributive shares are suspended is approximately 4.4%. If distributive shares are suspended, the build-equity premium required is 5.6% and the build-plus-pay distributive shares premium is 6.0%. Because the premium can be financed, the "true" loan-to-value ratio increases, as does the ultimate claim rate. The following table illustrates the impact of this policy on ultimate claim rates and the present value of the business.

	Ultimate Claim Rate	Net Present Value of Business
Premium = 3.8%	11.5%	(\$208) M
Premium = 4.5%	11.7%	\$36 M
Premium = 5.0%	11.9%	\$209 M
Premium = 5.5%	12.0%	\$381 M
Premium = 6.0%	12.1%	\$550 M

As illustrated, although the net value of the business has improved under the 6.0% premium policy, the risk of this business has increased because the ultimate claim rate is 0.6 percent higher than currently. The increased risk of this policy serves to deteriorate the net worth of the business under more adverse economic conditions.

Policy Scenario 2 -- Raise the Required Downpayment

The Fund's financial position can also be improved by restricting FHA from writing high risk loans. Because risk is most directly reflected in the loan-to-value ratio, this policy would require a higher minimum downpayment. By excluding riskier loans, the premium charge is more consistent with individual loan risk (the cross subsidization from low LTV borrowers is reduced).

Advantages:

- Improves the equity position of the borrower and thus reduces the risk of default.
- Will not induce adverse selection because the downpayment is raised least for the least risky current borrowers.

Disadvantages:

- Requires an increased cash investment for the borrower at closing. During fiscal year 1989, approximately 215,000 borrowers put less than 5 percent down and another 168,000 put between 5 and 10 percent down. These borrowers account for 40 and 32 percent, respectively, of MMI loans endorsed in 1989. Depending on the severity of the new downpayment requirement, these borrowers would have to accumulate anywhere from \$1,000 - \$7,000 more in up-front cash. This will require potential homebuyers to wait longer to buy a home.

In order for MMI to break even under this policy option, the required downpayment would have to be about 5.75% of the home value, premium, and closing costs. To build equity equal to 1.25 percent of the net increase in insurance-in-force, roughly a 10% downpayment would be required. To do this and continue to pay distributive shares, the downpayment requirement must be increased to approximately 11%. The following table illustrates the effect on the up-front cash requirement of homebuyers when downpayment requirements are raised.

	Ultimate Claim Rate	Net Present Value of Business	Increase in Cash Required Up-front
Current Policy	11.5%	(\$208) M	--
Downpayment = 5%	10.2%	(\$86)M	1.3% -- 2.3% *
Downpayment = 7%	9.5%	\$47 M	3.5% -- 4.5% *
Downpayment = 10%	5.4%	\$430 M	6.7% -- 7.7% *

*Percentage of the mortgage amount; values given for \$100,000 and \$50,000.

Under all of the policies that increase downpayment requirements, the borrower is still allowed to finance the majority of the premium and closing costs. Thus, the true LTV is approximately 6.8 percentage points higher than the FHA-defined LTV. In comparison, private mortgage insurers insure loans with a minimum downpayment requirement of 5.0% but do not allow financing of the premium or closing costs and, therefore, their loans have a maximum true LTV of 95%.

Policy Scenario 3 -- Restructure the Premium

In 1983, the FHA insurance premium was changed from a "pay-as-you-go" structure to an up-front payment. Because the up-front premium can be financed, the impact on the borrower is minimized. However, FHA receives cash earlier under the current policy.

As discussed earlier, the major problems with the up-front premium are: (1) the ability to finance the premium may somewhat erode the borrower's equity, and (2) because the premium is financed, FHA effectively collects virtually none of the premium when a loan defaults.

One policy option is to reduce the up-front premium and return to a more "pay-as-you-go" structure. The alternative we examined requires an initial, non-refundable fee and an annual payment of one-half of one percent of the remaining loan balance.

Advantages:

- The premium is not financed.
- Borrowers defaulting in the third year will have paid a 2.25 to 2.60 percent premium, as opposed to almost nothing under current policy.
- Eliminates entirely the need to refund the premium when loans are refinanced.
- Provides flexibility. For example, if FHA finds that this structure brings in too much revenue, the annual charge can be stopped after a given number of years. Alternatively, excess premiums can be distributed back to borrowers.
- Would not substantially increase the initial cash required by the borrower.

Disadvantages:

- Some adverse selection might be expected. (Lower LTV borrowers are more likely to shift to conventional loans than are higher LTV borrowers.) To minimize adverse selection, a variation of this policy that allows for a risk-based premium structure could be developed.
- Moving away from an up-front premium will substantially decrease cash inflows to the Treasury. The resulting impact on the government's deficit is unfavorable. To lessen the impact on the budget, we suggest a phase-in of this policy over five years.

MMI FUND ANALYSIS

We estimate that if one percent is paid in cash up-front and one-half of one percent is paid annually for fourteen years, the value of new business will be positive. To build equity, 1.35 percent must be paid up-front and 0.5 percent must be paid over the full term of the mortgage. Another 0.25 percent is needed up-front to pay distributive shares. The impact of alternative combinations on the claim rate, NPV of the business, and the up-front cash required is:

	Ultimate Claim Rate	Net Present Value of Business	Increase in Cash Required Up-front
Current Policy	11.5%	-\$208 M	--
1% Up-front / 0.5% annually for 14 years	11.7%	\$11 M	1%*
1.25% Up-front / 0.5% annually for 30 years	11.5%	\$350 M	1.25%*
1.5% Up-front / 0.5% annually for 30 years	11.1%	\$494 M	1.5%*

*Percentage of the mortgage amount.

This restructuring can be implemented gradually. One possible phase-in schedule is detailed below:

Year	Cash Up-front	Financed Up-front Premium	Annual Premium
1	1.25%	3.2%	0.1%
2	1.25%	2.4%	0.2%
3	1.25%	1.6%	0.3%
4	1.25%	0.8%	0.4%
5	1.25%	0.0%	0.5%

The above schedule provides for an equal net present value of premiums for each of five phase-in years, while preventing a large, immediate drop in cash flows. The long-term benefits of the 1.25 percent up-front / 0.5 percent annual premium are preserved, and the possible short-term negative effects on the Fund's cash position and therefore on the government's deficit are minimized.

Policy Scenario 4 -- Set Risk-based Premiums

MMI could improve the financial performance of its new business by setting premiums based on loan risk. This policy would allow MMI to increase the premium required for loans that are most risky, while not increasing the burden on its less risky, more profitable business. Thus, a major disadvantage of increasing the premium -- causing adverse selection -- is circumvented.

MMI FUND ANALYSIS

In analyzing such a policy, we categorized the loans into four risk classes based on their initial LTV: (1) less than 90%, (2) 90% - 93%, (3) 93% - 95%, and (4) greater than 95%. We maintain the basic 3.8 percent up-front premium but add a 0.5 percent annual premium to higher LTV loans for a number of years. The years of the 0.5 percent premium is paid for two alternative policies are listed below.

LTV	Build Equity		Build Equity and Pay Distributive Shares	
	Years of 0.5% Premium	Present Value of Premium	Years of 0.5% Premium	Present Value of Premium
<u>Option 1:</u>				
< 93%	0	3.8%	0	3.8%
> 93%	11	7.1%	15	7.5%
<u>Option 2:</u>				
< 90%	0	3.8%	0	3.8%
90% - 93%	4	5.4%	4	5.4%
93% - 95%	7	6.3%	10	6.9%
> 95%	11	7.1%	15	7.5%

The reduction in the cross-subsidy among different LTV borrowers caused by these variations in the premium are indicated below. The cost of the insurance relative to the premium received is approximated by the ratio of the historic average claim rate to the present value of the premium paid, where a higher value indicates a better deal for the borrower. Under current policy, higher LTV borrowers have a much better deal than lower LTV borrowers. In fact, those with LTVs over 95 percent pay less than half as much per unit risk as those with LTVs under 90 percent. With the risk-varying premiums, the cross subsidies are sharply reduced.

LTV	Claim Rate*	Claim Rate / Present Value of Premium		
		Current Policy	Build Equity	Build Equity & Pay Dist. Shares
<u>Option 1:</u>				
< 93%	4.0	1.05	1.05	1.05
> 93%	7.6	2.00	1.08	1.01
<u>Option 2:</u>				
<90%	3.5	0.92	0.92	0.92
90% - 93%	4.9	1.29	0.90	0.90
93% - 95%	6.4	1.68	1.02	0.93
> 95%	8.0	2.11	1.13	1.06

*Claim rates from Exhibit II-2; where averages of weights are calculated, we use the distribution of the 1988-89 business from Exhibit II-8.

Policy Scenario 5 -- Raise the Loan Limits

Loans above \$101,250 are less risky than smaller loans under current FHA policy because the minimum downpayment requirement on that part of the loan above \$101,250 is 10 percent. In addition, our analysis of the FHA portfolio found that the risk of default declines slightly with the size of the loan. Most of this effect, however, is found as loan sizes increase from the smallest loans up to \$40,000. Very little difference is found between \$50,000 and \$100,000 loans.

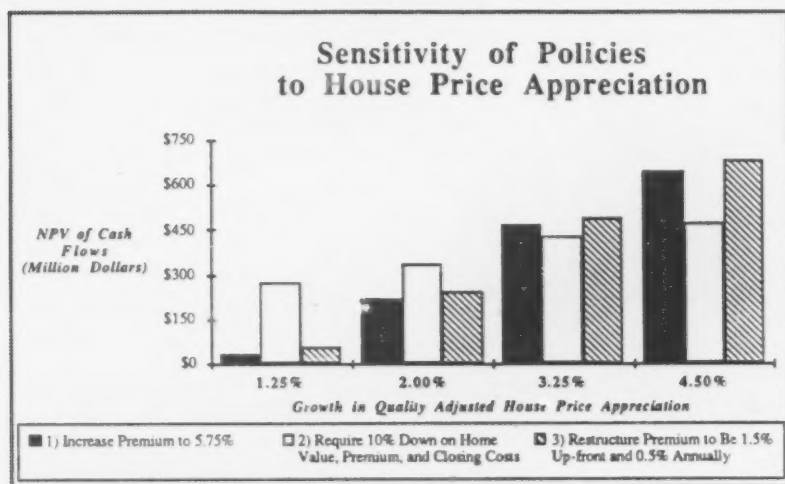
Increasing the loan limit to 95% of the state median house price is estimated to increase FHA 1990 business from \$48 billion to \$54 billion. Under FHA's current policies, the loan limit is 95% of an area's median home price limited to \$125,000. With the higher loan limit, a policy of charging a 1.5% non-refundable cash premium up-front and 0.5% of the outstanding mortgage balance over the life of the loan is estimated to produce a 1990 book of business with equity of \$572 million or \$78 million more than the same policy produces without the higher loan limit. While increasing the loan limit would increase the value of the Fund under the policy analyzed, the \$6 billion in additional business means that the Fund is subject to greater risk. In fact, \$75 million of the \$78 million additional capital produced by this policy is required as additional capital to meet the 1.25 percent of insurance standard.

Raising the loan limit raises another issue. One can rationalize having MMI premiums that build only enough capital to withstand a recession, while most private insurers must have sufficient capital to withstand a depression, on the basis of the social purpose of the MMI Fund. However, as the MMI insures higher and higher income households, the social purpose argument becomes less compelling, and, thus higher capital standards and insurance premiums become more appropriate.

C. Relative Sensitivity of Alternative Policies to Changes in Economic Conditions

The ability of the Fund to build equity under these policy options depends heavily on the economic conditions assumed. These policies were calibrated to provide roughly the same \$450 million assuming consensus economics (3.25 percent quality-adjusted house price appreciation). Exhibit IV-2 illustrates the sensitivity of the net present value of the 1990 business to changes in quality-adjusted house price appreciation.

EXHIBIT IV-2



As can be seen, the Fund value is far less sensitive to economic conditions if the option of raising the downpayment is adopted rather than if the premium increase / restructure options are chosen. If the downpayment option were adopted, the required capital standard on new business for MMI could arguably be lowered to, say, one percent of insurance-in-force and thus the required increase in the downpayment would be less.

D. Conclusions

The policy options discussed above improve the financial performance of new business by increasing revenues generated by new business and/or reducing losses incurred by new business. Raising the insurance premium is a simple method to generate higher revenue. However, because MMI allows the premium to be financed, the true LTV of these loans is increased and, thus, risk also increases.

Similarly, restructuring the premium can increase the Fund's revenue. In addition, because borrowers are required to put down the up-front portion in cash, this policy enables FHA to collect a larger portion of the premium on those loans that default. However, this policy does very little to reduce the risk of the business. When possible, borrowers who are forced to put cash up-front for the premium will use cash from their current downpayment and consequently will not reduce the amount of their mortgage. In addition, borrowers view the annual mortgage premium as an increased mortgage obligation, and therefore, their equity is reduced. As illustrated in Exhibit IV-2, both raising and restructuring the premium are very sensitive to changes in economic conditions because they do not reduce the risk of the new

business. In addition, both of these policies could lead to adverse selection (less risky borrowers opting for conventional loans).

In contrast, raising the downpayment requirement reduces the sensitivity to changes in economic conditions. Because their initial equity is much stronger under this policy, borrowers are not as sensitive to changes in house price appreciation. Of course, unlike raising or restructuring the premium, this policy requires substantially more up-front cash from borrowers. Finally, neither raising the downpayment nor raising the premium only for riskier borrowers will lead to adverse selection.

APPENDIX A

MMI FUND ANALYSIS

APPENDIX A: ANALYSIS OF LOAN PERFORMANCE

This appendix focuses on the behavior of conditional claim rates and conditional prepayment rates for 30-year fixed-rate loans originated between 1975 and 1989. Economic models are developed to explain the probability of claim and non-claim termination and in turn are used to project claims and prepayments over the life of the mortgage. The forecasts of claims and prepayments under alternative economic scenarios are incorporated into the cash flow and financial analysis of the MMI Fund.

I. APPROACH AND METHODOLOGY TO ESTIMATE CONDITIONAL CLAIM RATES

An economic model is formulated for conditional claim rates of FHA-insured loans and estimated to determine the sensitivity of economic and policy factors that impact loan performance. The model is estimated using data for loan origination years 1975 through 1987 and associated historical policy years through 1989. The results of this estimated model are used to project FHA-insured loan conditional claim rates for the 1975-89 loan origination years and their associated future policy years.

A. Economic Model

The economic model is developed from the theory of consumer choice to identify expected mortgage borrower's behavior under an objective of maximizing the expected wealth at termination of the mortgage. Four choices are available to borrowers in the course of meeting their mortgage obligations:

- 1) default on mortgage,
- 2) prepay through refinancing,
- 3) prepay through sale, and
- 4) continue paying mortgage.

The borrowers choose the option that maximizes the discounted value of expected wealth over time. We initially focus on the loan default option. The prepayment options are considered in the next section.

Using this wealth maximizing approach, borrowers' decision to default will be determined largely by their perceptions of home equity and whether or not they desire or are forced to move. Specifically, when real estate markets experience significant and sustained declines, homeowners may be able to maximize their wealth by walking away from the property. This choice will be exercised when the resale value of the home falls sufficiently below the market value of the remaining mortgage balance to outweigh the costs of default, both economic and non-economic. Alternatively, when a household is forced to move, a resale value net

of selling costs that exceeds the value of the mortgage may be sufficient to trigger default. Thus events such as divorce and unemployment that can cause households to move are likely to be associated with higher default rates.

The conditional claim rate, $CCR_{i,t}$ for FHA insured mortgages originated in year j that have been foreclosed in year t can be expressed as

$$CCR_{i,t} = f(E_{i,t}, U_{t-1}, SD\_RCQHP_t, D_1 \dots D_n) \quad 1)$$

where:

- $E_{i,t}$ - the net equity as a percent of the current market value in the property,
- U_{t-1} - the unemployment rate lagged one policy year,
- SD_RCQHP_t - a house price dispersion index defined as the standard error of the regional percentage changes in constant quality house price index since the mortgage was originated divided by one plus the percentage change in the national constant quality house price index since mortgage origination,
- D_n - dummy variable for each of n policy years taking on a value of one in the respective policy year and zero otherwise.

The conditional claim rate model employs information about economic conditions and specific loan characteristics to explain borrower default behavior. The conditional claim rate is used instead of a default rate measure because the model explains the rate of FHA claim payment on mortgages that have moved from default to bank foreclosure. Default rates summarize the economic events associated with the consumer choice concerning mortgage payment. A portion of mortgage defaults will be cured thus not generating a claim filing on the part of the bank. However, the rate of claim payout follows directly from default and occurs with a lag due to administrative and statutory considerations. Therefore, a default rate model can be used to estimate claim rates with appropriate lag specification.

B. Measure of Net Equity

In general, increases in net equity in properties will lower the expected default incidence. Higher home price appreciation will increase homeowner equity, as will decreases in the market value of the mortgage liability. The mortgage can be viewed as an obligation to make periodic principal and interest payments with the expectation that prepayment of the mortgage will occur before maturity. The present value is obtained for these payments using the current mortgage interest rate as the discount rate. When the current interest rate falls below (rises above) the original loan contract rate, the market value of the mortgage rises above (falls below) the remaining balance.

MMI FUND ANALYSIS

The FHA 3.8 percent up-front premium payment policy initiated in 1984 has an asset value to the borrower associated with the policy to refund the unearned portion of the paid-in premium. Thus the asset value of the premium refund is included in the determination of the net equity index. The asset value of the premium refund depreciates quickly in accordance with the refund policy as the FHA recognizes as "earned revenue" the up-front premium cash receipts; after seven years the refund value diminishes to less than one percent.

The net equity index in policy year t for properties purchased in year j is

$$EI_{j,t} = \frac{P_0 \cdot (1 + r_{j,t} - 0.01)^t + M_0 \cdot \text{PREM}_{j,t} - M_0 \cdot MV_{j,t}}{P_0 \cdot (1 + r_{j,t} - 0.01)^t} \quad 2)$$

where:

- P_0 - the purchase price of the property,
- $r_{j,t}$ - the annual rate of change in the constant quality price index from loan origination to policy year t which, net of one percent depreciation, is used to grow property value over time,
- $\text{PREM}_{j,t}$ - the refund value of the premium expressed as a percent of the total loan amount,
- M_0 - the total mortgage amount including the financed premium amount,
- $MV_{j,t}$ - the discounted value of amortized mortgage payments plus a future prepayment amount for a one dollar mortgage.

Cancelling P_0 and substituting LTV_c for M_0 / P_0 , the conventional definition of the loan-to-value ratio, yields,

$$EI_{j,t} = \frac{(1 + r_{j,t} - 0.01)^t + \text{LTV}_c \cdot \text{PREM}_{j,t} - \text{LTV}_c \cdot MV_{j,t}}{(1 + r_{j,t} - 0.01)^t} \quad 3)$$

FHA policy allows one to borrow both a fraction, LTV_n , of the value of the property, allowed closing costs and the insurance premium equal to 3.8 percent of the former. If allowable closing costs equal c percent of P_0 and the premium is borrowed, then,

$$M_0 = \text{LTV}_n \cdot (1 + c) \cdot (1.038) \cdot P_0 \quad 4)$$

Dividing by P_0 , the relationship between the conventional LTV_c and the FHA loan-to-value ratio, LTV_n , is:

$$\text{LTV}_c = \text{LTV}_n \cdot (1 + c) \cdot (1.038) \quad 5)$$

Assuming that allowable closing costs are 3.0% on the property value, the effective loan-to-value, LTV_c , is 1.069 times the FHA definition. That is, the maximum FHA LTV_n of 97% is equivalent to a LTV_c of 103.7% and as such gives the borrower a negative net equity position at loan origination, before consideration of the remaining premium refund value. The measure of contemporaneous net equity for the borrower can thus be expressed as

$$EI_{j,t} = \frac{(1 + r_{j,t} - 0.01)^t + LTV_j \cdot (1.0694)^t \cdot (PREM_{j,t} - MV_{j,t})}{(1 + r_{j,t} - 0.01)^t} \quad (6)$$

The market value of an original one-dollar mortgage, $MV_{j,t}$, is formally defined as the discounted value of expected future principal and interest payments plus the present value of an expected future prepayment of the remaining balance on the mortgage¹. It is presumed that the borrower will not hold the mortgage for the full term, but rather will prepay at 40% of the remaining life.

Large drops in prevailing interest rates below the original contract rate could lead to default. Defaulting, however, is not the only, or even generally the preferred way to end a high coupon mortgage. Such a mortgage can be refinanced. To account for this, if the current coupon falls over 3 percentage points below the original loan contract rate, we use the original contract rate less three points as the discount rate.

Table A.1 shows, for loans that originated in 1983, the fluctuations in net equity index from 1983 through 1989. The higher LTV loans have a precariously low if not negative equity position for some time. Further, when current mortgage interest rates move above or below the contract rate, this carries through to the net equity value index. Over time the longer term tendency toward increasing house prices (captured by growth in constant quality house prices) coupled with the amortization of the mortgage balance (measured by the mortgage value) begins to dominate, and the equity index increases significantly. Not surprisingly, the experience with loan default is that the risk is most pronounced in the early years and diminishes significantly in the later years.

TABLE A.1
EQUITY INDEX FOR 1983 ORIGINATED LOANS BY LTV
Original Mortgage Contract Rate: 12.4%

YEAR	POLICY YEAR	NEW		GROWTH CONSTANT QUALITY HP	LTV				
		ISSUE RATE	MORTGAGE VALUE		80%	87.5%	91.5%	94%	96%
1983	1	13.4	0.971	1.015	0.212	0.138	0.098	0.074	0.054
1984	2	13.8	0.945	1.043	0.254	0.184	0.146	0.123	0.104
1985	3	12.9	0.989	1.067	0.236	0.164	0.126	0.102	0.083
1986	4	10.7	1.109	1.085	0.157	0.078	0.036	0.010	-0.011
1987	5	9.9	1.153	1.092	0.130	0.048	0.005	-0.022	-0.044
1988	6	10.5	1.111	1.098	0.166	0.088	0.046	0.020	-0.001
1989	7	10.5	1.094	1.112	0.190	0.114	0.073	0.048	0.027
1990	8	10.3	1.095	1.129	0.201	0.126	0.086	0.061	0.041

¹It is assumed that the up-front premium was financed and therefore, included in the total mortgage. This increases the annual mortgage liability payments. For mortgages originated before 1984 a 0.5 percent annual premium policy was in effect. In our analysis the 0.5 percent premium was added to the mortgage coupon each year in determining the mortgage payments and thus market value of the mortgage. This procedure is also followed in our analysis of the policy re-introducing the 0.5 percent premium.

The contemporaneous net equity index captures the joint effects of house price fluctuations, interest rate movements and initial LTV. Higher LTV ratios at loan origination will lower the net equity position and thus will increase the risk of loan default. The experience of FHA-insured loans indicates that the default rates not only increase for higher LTVs also accelerate at levels above 90%. The acceleration effect will not be captured in this specification. Therefore, separate regression models are estimated for each of the LTV categories.

C. Variability in Regional House Price Appreciation

The analysis of loan default focuses on explaining default behavior for groups of borrowers based on characteristics deemed to be important to determining the probability of loan default. In doing so, a national measure of the average rate of change in house prices has been employed in computing the equity index. While house prices have increased consistently when measured on a national aggregate basis, when viewed in terms of the four census regions, more variability in house price movements occur. Further disaggregation into twelve regions shows even more pronounced fluctuations in house price movements in both a positive and negative direction. It is expected that the low or negative price movements in selected regions will have a greater contribution to the likelihood of default and foreclosure; macro indicators will not capture adequately the causal relationship between weak house price appreciation in localized areas and the probability of default and foreclosure.

While the average property is experiencing positive growth in house value so that widespread borrower default is not likely, there may be some borrowers who are at risk because their regional or individual housing market is experiencing falling house prices. It is the borrowers in the tail of a distribution for national house price appreciation that are at greatest risk of default. Increased volatility of house price movements will have an associated increase in properties that have small or negative changes in their house value. This dispersion in house price appreciation over time should be directly linked to fluctuations in the aggregate variation in default rates associated with the concentration of default incidence in regionally stressed areas.

To test the effects of the dispersion in house price appreciation across regions on aggregate default rates, an index has been constructed using the four regional constant quality house price indexes from the Bureau of the Census. First, for each of the regions and the nation in aggregate, the ratio of the constant quality house price index in year t to the value in the origination year is computed. Then for each loan origination year and policy year the standard deviation of these regional ratios is computed and divided by the national ratio to provide a measure of relative dispersion in house price appreciation. Deflating the standard deviation in house price variation by a national ratio adjusts for the general overall trend in house prices.

MMI FUND ANALYSIS

Table A.2 presents the dispersion index. The average for each policy year is reported in the far right column². As can be seen by concentrating on the data between the jagged lines, for all loan origination years the index jumps for the policy years between 1985 and 1987, reflecting the experience in the oil patch states.

TABLE A.2

HISTORICAL DISPERSION IN HOUSE PRICE APPRECIATION Across Four Census Regions Using Constant Quality House Prices																
POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	AVERAGE	
1	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
2	2.1	3.0	3.3	1.5	2.1	1.5	1.2	2.9	3.3	4.2	7.9	4.6	2.7	1.9	3.0	
3	4.9	6.3	4.4	3.3	2.1	2.3	2.3	5.2	7.0	12.4	13.1	6.5	2.5		5.6	
4	8.0	7.3	5.6	2.8	2.4	3.3	4.7	9.6	15.7	17.9	14.7	6.6			8.2	
5	8.9	8.2	4.3	2.5	4.3	6.0	9.0	18.7	21.6	19.4	14.8				10.7	
6	9.5	6.6	3.7	4.8	6.1	10.1	17.9	24.8	23.3	19.6					12.6	
7	7.9	6.1	4.9	6.1	10.4	19.0	23.9	26.4	23.4						14.2	
8	7.6	6.3	2.4	10.6	19.0	25.0	25.5	26.5							15.6	
9	7.1	4.3	8.4	19.2	24.9	26.6	25.6								16.6	
10	4.5	6.8	16.6	25.2	26.4	26.7									17.7	
11	5.5	14.2	22.4	26.6	26.5										19.0	
12	12.0	19.6	23.6	26.8											20.5	
13	17.2	20.7	23.9												20.6	
14	18.2	21.2													19.7	
15	18.7														18.7	

D. Additional Economic Indicators Used in the Analysis

Some of the other raw data used in the estimation are reported in Table A.3; the claim, prepayment and conditional probabilities are listed at the end of Appendix C.

²An index computed from data supplied on 12 Census sub-regions looks very similar to that in Table A.2. Forecast scenarios of house price dispersion are developed with reference to the average dispersion over the period 1975-89. Specifically, for the baseline case 90 percent of the average dispersion was applied; for the moderate 70 percent of average was applied; and for the severe case 100 percent was applied for the first 5 years, 110 percent above the 1975-88 average for the next 2 years, 120 percent above average for policy years 8 through 12 and 130 percent for the remaining policy years.

TABLE A.3

HISTORICAL DATA OF ECONOMIC VARIABLES USED IN THE ANALYSIS Referenced on a Fiscal Year Basis				
YEAR	CONSTANT QUALITY HOUSE PRICES	FHA CONTRACT INTEREST RATE	FREDDIE MAC COMMITMENT RATE	UNEMPLOYMENT RATE
1975	49.8	8.63%	9.20%	8.1%
1976	54.0	8.50	8.94	7.8
1977	59.1	8.25	8.82	7.3
1978	67.3	9.02	9.34	6.0
1979	77.4	9.96	10.61	5.8
1980	86.2	12.23	13.23	6.8
1981	94.7	15.10	15.76	7.4
1982	100.1	14.71	17.02	9.1
1983	101.8	12.38	13.37	10.1
1984	105.9	13.18	13.82	7.8
1985	109.7	11.85	12.91	7.3
1986	112.9	9.64	10.70	7.0
1987	115.6	9.87	9.90	6.4
1988	116.8	10.22	10.45	5.6
1989	119.2	10.16	10.47	5.3

E. Level of Aggregation in the Analysis

The conditional claim rate model employs data aggregated from the individual loan records to specified loan categories. The analysis is conducted by pooling the time series of loan performance over the 1975-89 policy years for individual specified loan categories of loan size, LTV and the 1975-87 loan origination years. The time series of loan performance for each loan origination year extends from loan origination to the present (1989) comprising up to fifteen policy years. The 1988 and 1989 loan origination years were excluded because there is insufficient claim history to be included in the analysis. Also excluded are the claim rates in the loan origination year. These claim rates are consistently about 0.015 percent and including this data in the analysis could distort the overall results without providing any meaningful information.

In estimating the claim rate profile the loan data are disaggregated across seven loan size categories and six LTV categories. The loan size categories are established with reference to the 1979 nominal price of properties. The loan size categories in subsequent years will increase or decrease according to changes in the constant quality house price index. This will enable comparisons of loans over time as the nominal value of the loans changes.

The LTV categories are defined so as to capture the expected acceleration in the conditional claim rate at the higher LTVs. A wider LTV category definition has been established for the lower LTVs from 75-90 percent, while smaller demarcations have been setup for the LTVs between 90-97 percent. All loans that have an LTV below 75 percent, comprising about 12 percent of loans, were excluded directly from the model estimation because of suspect LTV measurement.

MMI FUND ANALYSIS

These were later included in the forecast simulation as part of the 75-85 percent LTV category because their default rates approximated those of the 75-85 percent category. The FHA experience suggests that the conditional claim rates accelerate when the original LTV moves above 90 percent. Separate models are estimated for each of the six LTV categories. The pooling of data for each equation is shown in Table A.4 below.

TABLE A.4

GROUPING OF DATA ACROSS LOAN SIZE CATEGORY AND POLICY YEAR				
ORIGINATION YEAR	(000) NUMBER OF MORTGAGES	(1) POLICY YEARS	(2) LOAN SIZE CATEGORIES	(3)=(1)*(2) NUMBER OF OBSERVATIONS
1975	185	14	7	98
1976	219	13	7	91
1977	252	12	7	84
1978	259	11	7	77
1979	267	10	7	70
1980	230	9	7	63
1981	163	8	7	56
1982	118	7	7	49
1983	410	6	7	42
1984	234	5	7	35
1985	324	4	7	28
1986	770	3	7	21
1987	923	2	7	14
TOTAL OBSERVATIONS FOR EACH ESTIMATED MODEL				728

F. Model Estimation

Preliminary review of the data suggests that the conditional claim rate profile takes the shape of a lognormal distribution thus supporting our basis for the semi-log transformation. The semi-log functional form for the above general model specification is estimated. The transformed model can be stated as:

$$\log(CR)_{j,t} = \beta_{0j} + \sum \beta_{ij} * X_{ij,t} + e_{j,t} \quad (7)$$

Time series data of conditional claim rates for thirteen loan origination years, j , and up to fifteen policy years, t , are combined with cross sections of data, j , defined by six LTV categories and seven loan amount categories. A generalized least squares (GLS) estimator with weights taken as the number of surviving loans to each policy year for each of the loan origination years and specific loan category was applied. While the estimated transformed model can be used to simulate and forecast $CR_{j,t}$, the statistical results are optimized only for simulating $\ln(CR)_{j,t}$. That is, on average the predicted $\ln(CR)_{j,t}$ is equal to the average of $\ln(CR)_{j,t}$, while the average predicted $CR_{j,t}$ will not necessarily equal the average $CR_{j,t}$. Therefore, the semi-log specification may introduce a bias into the projections of claim rates for the different cross sections and time periods.

G. Results for the Analysis on Conditional Claim Rates

The estimates of the coefficients in the claim rate model are presented in Table A.5. In general, the results support prior expectations about the economic forces causing claim termination. Specifically, the conditional claim rate profile over policy years and across pre-defined loan categories can be explained largely by changes in net equity, house price dispersion and unemployment.

These results further indicate that the influence of equity has varied across LTV categories. The negative coefficients on the equity variables indicate that increases in equity will reduce the probability of claim termination. Larger negative coefficients on the equity variable are associated with a lower likelihood of default. Comparison of the separate regression results across LTV categories shows that the negative effect of the equity variable increases for higher LTVs (takes a smaller negative value). Further, when estimating the additional effects of equity for lower valued loans (loan size categories 1 and 2 with 1979 prices less than \$30,000), the positive coefficients add to the default risk. These basic results reflect the fact that low valued loans and loans with high LTVs have significantly higher risk of default and claim termination.

Examination of the residuals in preliminary regressions revealed a substantial over-prediction of defaults in the 1975-78 period and offsetting under-prediction in later years. Allowing for a structural shift in the propensity to default for a given level of equity after 1978 indicated a substantial difference; for a given level of equity the borrower is at least 60 to 120 percent more likely to default in the post-1978 period than earlier. This shift in default proclivity in the 1980s is even more pronounced for higher LTVs.

A dynamic adjustment of claim termination has been identified for the period after 1978 and was captured by including a one-year lag effect of equity on the conditional claim rate. These results indicate that the decision to exercise the option to default tends to be postponed or extended. The lag adjustment effect is only significant for loans with above 90 percent LTVs where the risk of default are the highest.

Price Waterhouse
A-9

Table A.5

REGRESSION RESULTS FOR CONDITIONAL CLAIM RATE MODELS Six Loan-To-Value Categories						
INDEPENDENT VARIABLES	LTV	LTV	LTV	LTV	LTV	LTV
	75-85%	85-90%	90-93%	93-95%	95-97%	INVESTOR
INTERCEPT	-4.935 (1.45)	-5.717 (0.87)	-1.469 (0.65)	-2.142 (0.53)	-1.043 (0.34)	-1.844 (0.74)
POLICY YEAR:						
TWO	3.885 (1.29)	3.738 (0.74)	0.031 (0.56)	0.848 (0.46)	-0.065 (0.30)	0.840 (0.64)
THREE	5.173 (1.26)	4.668 (0.72)	1.063 (0.54)	1.841 (0.45)	0.879 (0.29)	1.856 (0.63)
FOUR	5.480 (1.24)	4.721 (0.70)	1.311 (0.52)	2.038 (0.43)	1.075 (0.28)	2.040 (0.61)
FIVE	5.273 (1.22)	4.311 (0.68)	1.107 (0.51)	1.876 (0.43)	0.896 (0.27)	1.817 (0.60)
SIX	5.501 (1.21)	3.723 (0.68)	1.022 (0.50)	1.707 (0.42)	0.645 (0.27)	1.740 (0.60)
SEVEN	5.127 (1.20)	3.640 (0.67)	0.889 (0.50)	1.431 (0.42)	0.456 (0.27)	1.451 (0.59)
EIGHT	4.923 (1.20)	2.923 (0.67)	0.448 (0.50)	1.164 (0.42)	0.251 (0.27)	1.112 (0.59)
NINE	4.263 (1.20)	2.718 (0.67)	0.168 (0.50)	1.010 (0.42)	0.141 (0.27)	0.959 (0.59)
TEN	4.610 (1.20)	2.496 (0.67)	-0.477 (0.49)	0.813 (0.41)	-0.030 (0.26)	0.558 (0.59)
ELEVEN	3.770 (1.21)	1.873 (0.67)	-0.143 (0.49)	0.613 (0.41)	-0.035 (0.27)	0.397 (0.59)
TWELVE	2.439 (1.23)	0.698 (0.68)	-0.267 (0.50)	0.156 (0.42)	-0.049 (0.27)	-0.132 (0.61)
THIRTEEN	3.424 (1.28)	1.191 (0.70)	-0.092 (0.51)	0.123 (0.43)	-0.102 (0.28)	-0.959 (0.63)
FOURTEEN	2.127 (1.38)	0.066 (0.76)	-0.971 (0.55)	-0.571 (0.46)	-0.115 (0.30)	-1.350 (0.67)

MMI FUND ANALYSIS

Table A.5(Cont'd)

REGRESSION RESULTS FOR CONDITIONAL CLAIM RATE MODELS Across Six Loan-To-Value Categories						
INDEPENDENT VARIABLES	LTV 75-85%	LTV 85-90%	LTV 90-93%	LTV 93-95%	LTV 95-97%	LTV INVESTOR
EQUITY:						
OVERALL	-5.055 (0.75)	-2.812 (0.46)	-2.386 (0.69)	-2.728 (0.55)	-1.896 (0.36)	-4.187 (0.35)
PRE 1978 PERIOD ONLY (1975-77=1, 1978=0.5)	-3.028 (0.49)	-1.216 (0.33)	-2.174 (0.75)	-1.386 (0.60)	-2.217 (0.40)	0.144 (0.26)
EQUITY(t-1) POST 1978	.	.	-1.138 (0.79)	-0.788 (0.63)	-1.651 (0.42)	.
EQUITY BY SIZE CATEGORY:						
ONE	2.787 (0.51)	3.539 (0.38)	2.902 (0.29)	2.540 (0.20)	1.946 (0.12)	2.097 (0.26)
TWO	.	1.524 (0.41)	1.267 (0.31)	1.481 (0.22)	1.108 (0.12)	1.594 (0.28)
SEVEN	-2.126 (0.71)	-3.365 (0.39)	-1.463 (0.27)	-6.220 (0.39)	-5.772 (0.43)	-3.621 (0.39)
PRE 1978 PERIOD ONLY						
UNEMPLOYMENT RATE(t-1)	0.082 (0.06)	0.151 (0.04)	0.125 (0.03)	0.135 (0.03)	0.164 (0.02)	0.148 (0.03)
HOUSE PRICE DISPERSION	5.038 (1.93)	12.947 (1.30)	7.003 (0.98)	7.239 (0.78)	5.658 (0.51)	6.138 (1.04)
SUMMARY STATISTICS						
Adjusted R-squared	0.58	0.69	0.71	0.78	0.83	0.68
Root Mean Squared Error	73.8	61.7	50.3	47.4	41.9	47.7
F-Statistic	53.6	81.2	85.7	122.9	173.9	78.6
Obs	728	728	728	728	728	728

Unemployment rates lagged one year have a positive impact on claim termination that is more influential at the higher LTV categories. This is consistent with the expectation that the likelihood of default increases when individuals become unemployed. Losing a job is not necessarily the basis for individuals to default on their mortgage. However, when considered in the context of a prolonged period of unemployment coupled with few alternate sources of cash equity in which to meet debt servicing requirements and/or little or no equity in the home, may force a decision to default. It is expected that changes in unemployment will accelerate (decelerate) the borrower's decision to default (continue paying) on the mortgage.

Impact of Policy Years using the zero-one indicator for each policy year following origination of the loan displays the expected profile of claim rates. The general profile shows that conditional claim rates increase to a peak in the fourth policy year. The consistency of this experience should be determined largely by economic information contained in the model. The inclusion of the zero-one indicator captures additional information concerning the underlying claim rate profile not

explained by the economic variables. The impact of the zero-one indicator variables becomes smaller and less significant for the higher LTV categories. Only in the generally risky policy years, two through seven, are the coefficients statistically significant across each of the regressions.

II. APPROACH AND METHODOLOGY TO ESTIMATE CONDITIONAL PREPAYMENT RATES

A model for conditional prepayment rates was developed to explain borrowers' decision to prepay their mortgage. The prepayment model is then used to project prepayment rates over future policy years.

A. Economic Model

An economic model for borrower prepayment behavior employs the same wealth maximizing consumer choice model used to formulate the claim rate model. In considering the four options for meeting their mortgage debt obligations, borrowers will choose the prepayment option when they expect this option to maximize their future real wealth. Consistent with the development of the conditional claim rate model, it is hypothesized that for a set of economic events we can estimate a conditional probability of exercising the option to prepay the mortgage. Aggregating across a class of borrowers, we formulate a model to explain the conditional rate of prepayment.

The model used to explain the prepayment rate or non-claim termination rate for FHA-insured loans in period t is

$$CPR_{j,t} = f(MV_t, RCURAVERT, RCURMIN_t, D_1, \dots, D_n) \quad 8)$$

where:

$CPR_{j,t}$ - is the conditional prepayment rate measured as the ratio of the number of non-claim terminations in a policy year to the number of loans surviving to that policy year,

MV_t - the same as defined above,

$RCURAVERT$ - the ratio of the current new issue coupon to the average coupon since origination or during the last six years, whichever is shorter,

$RCURMIN_t$ - the ratio of the current new issue coupon to the minimum coupon rate on FHA mortgage since origination,

D_n - Dummy variable for each of n policy years taking on a value of one in the respective policy year and zero otherwise.

The decision to prepay the mortgage loan depends on both the underlying mobility

of borrowers and the path of interest rates since the loan was originated. To capture the underlying mobility effect, zero-one indicator variables are included for each of the policy years following loan origination.

The impacts of the current interest rate level to prior period averages and/or levels have been captured through three constructed variables. The first is the ratio of the current market value of the mortgage to the current book value. If the market value of the debt exceeds the book value, owing to declines in interest rates, borrowers have an incentive to refinance (replace the current market value with debt equal in value to the current book value). The market value is computed as in the homeowner equity calculation, except here the discount rate is not constrained to the original coupon rate less three percent.

The specific time path of mortgage coupon rates since origination may also matter. For example, if rates initially rise for a while, this will discourage the normal prepayment of a mortgage because borrowers will not want to give up what has become a below market rate. Also, a decline in interest rates to, say, three percentage points below the original coupon may have a smaller impact on prepayment if this decline has previously occurred in the life of the mortgage (more sensitive prepayers will have already prepaid).

To capture these effects, we employ two additional variables: the ratio of the current new issue coupon to the average coupon over the previous six years (or shorter span if the mortgage is less than seven years old) and the ratio of the current new issue coupon to the lowest value coupon rates have taken on since the mortgage was originated. To allow different responses to rises and falls in rates, we estimate different coefficients for values of the variables above and below unity.

B. Data Disaggregation in the Analysis of Conditional Prepayment Rates

The analysis on loan prepayment pools the time series of policy years 1979-89 for nine loan origination years 1979-87 for seven loan size and six LTV categories. Table A.6 shows the distribution of data used in the analysis for each loan origination year, identifying the number of loan categories and possible policy years available.

Table A.6

GROUPING OF DATA ACROSS LOAN SIZE CATEGORY AND POLICY YEAR					
ORIGINATION YEAR	(000) NUMBER OF MORTGAGES	(1) POLICY YEARS	(2) CATEGORIES LOAN SIZE	(3) (4)=(1)*(2)*(3) NUMBER OF LTV OBSERVATION	
1979	267	11	7	6	462
1980	230	10	7	6	420
1981	163	9	7	6	378
1982	118	8	7	6	336
1983	410	7	7	6	294
1984	234	6	7	6	252
1985	324	5	7	6	210
1986	770	4	7	6	168
1987	923	3	7	6	126
TOTAL OBSERVATIONS AVAILABLE					2,646

The conditional prepayment model is estimated using a semi-log functional form. Preliminary estimation suggested differential behavior of mortgages with LTVs above and below 93 percent and of loans partitioned into four loan sizes. Thus, eight different cross sectional groupings across LTV and loan size categories are reported below. The range of observations varies from 126 to 504. A weighted least squares estimator is applied using as weights the number of loans that survive to the beginning of the policy year in each of the defined loan categories.

C. Results of the Estimation for the Conditional Prepayment Rate Model

The results of our estimated model shown in Table A.7 support the view that the probability of prepayment can be explained largely by the effects of changes in the current mortgage interest rates relative to both the mortgage contract rate at loan origination and the path of rates since origination. The positive relationship with the conditional prepayment rate indicates that increases (decreases) in the market value of the financial liability will raise (lower) the probability of loan prepayment. The mortgage value effect is stronger for loans at the higher LTV and loan size categories indicating a greater propensity to prepay for a given mortgage liability value.

Zero-one Indicators for policy years are used to capture an underlying profile of prepayment rates not reflected in the economic indicators. The coefficients show the additive effect of prepayment rates in each policy year to that measured by all other economic factors in the model. The results show that prepayment rates increase to a peak in the fourth to sixth policy year following loan origination and then gradually decrease in policy years thereafter.

MMI FUND ANALYSIS

Table A.7

CONDITIONAL PREPAYMENT RATE MODEL For Specified Categories of Loan Size and LTV								
LOAN SIZE CATEGORIES:	1	2 & 3	4 & 5	6 & 7	1	2 & 3	4 & 5	6 & 7
LTV RATIOS:	75-93%	75-93%	75-93%	75-93%	93-97%	93-97%	93-97%	93-97%
INDEPENDENT VARIABLES								
INTERCEPT	3.560 (1.88)	6.056 (1.33)	7.012 (1.55)	7.582 (1.83)	1.969 (1.34)	3.901 (1.31)	5.751 (1.52)	6.065 (2.04)
POLICY YEAR:								
ONE	-2.545 (0.54)	-2.747 (0.35)	-2.815 (0.42)	-3.342 (0.49)	-2.774 (0.32)	-3.508 (0.29)	-3.518 (0.33)	-4.041 (0.47)
TWO	-0.918 (0.54)	-1.062 (0.35)	-1.178 (0.41)	-1.480 (0.49)	-1.213 (0.31)	-1.686 (0.28)	-1.785 (0.33)	-2.111 (0.47)
THREE	-0.475 (0.53)	-0.611 (0.34)	-0.741 (0.41)	-0.851 (0.48)	-0.710 (0.31)	-0.972 (0.27)	-1.115 (0.32)	-1.236 (0.46)
FOUR	-0.274 (0.52)	-0.359 (0.34)	-0.480 (0.40)	-0.541 (0.48)	-0.418 (0.30)	-0.746 (0.27)	-0.782 (0.31)	-0.826 (0.45)
FIVE	-0.258 (0.53)	-0.272 (0.34)	-0.439 (0.41)	-0.584 (0.48)	-0.277 (0.30)	-0.623 (0.27)	-0.736 (0.31)	-0.844 (0.45)
SIX	-0.376 (0.54)	-0.402 (0.35)	-0.569 (0.41)	-0.714 (0.49)	-0.291 (0.31)	-0.600 (0.27)	-0.730 (0.32)	-0.954 (0.46)
SEVEN	-0.525 (0.54)	-0.564 (0.35)	-0.736 (0.42)	-0.845 (0.49)	-0.407 (0.31)	-0.726 (0.28)	-0.881 (0.32)	-1.059 (0.47)
EIGHT	-0.738 (0.57)	-0.846 (0.38)	-0.912 (0.45)	-0.890 (0.53)	-0.540 (0.33)	-0.823 (0.30)	-0.887 (0.35)	-0.869 (0.51)
NINE	-0.628 (0.58)	-0.754 (0.38)	-0.800 (0.45)	-0.756 (0.53)	-0.510 (0.33)	-0.729 (0.30)	-0.814 (0.35)	-0.775 (0.50)
TEN	-0.437 (0.60)	-0.302 (0.39)	-0.370 (0.46)	-0.408 (0.55)	-0.246 (0.34)	-0.336 (0.30)	-0.401 (0.35)	-0.351 (0.51)
MORTGAGE VALUE	2.798 (0.77)	3.537 (0.55)	4.217 (0.65)	4.599 (0.78)	2.984 (0.53)	4.251 (0.52)	4.694 (0.62)	5.547 (0.87)
CURRENT NEW ISSUE RATE RELATIVE TO:								
PRIOR 6 YEAR MOVING AVERAGE	-4.377 (1.63)	-4.687 (1.15)	-4.780 (1.34)	-3.473 (1.57)	-3.142 (1.20)	-3.377 (1.15)	-3.410 (1.33)	-2.182 (1.76)
LIMITED TO MAX VALUE OF 1.0								
PRIOR MINIMUM NEW ISSUE RATE	-0.948 (1.75)	-2.412 (1.25)	-3.427 (1.44)	-4.437 (1.67)	-1.187 (1.34)	-3.007 (1.30)	-4.411 (1.50)	-5.583 (1.92)
LIMITED TO MAX VALUE OF 1.0								
PRIOR MINIMUM NEW ISSUE RATE	0.240 (0.70)	-1.012 (0.46)	-1.398 (0.54)	-2.254 (0.63)	0.466 (0.45)	-0.244 (0.41)	-0.908 (0.47)	-1.671 (0.65)
LIMITED TO MIN VALUE OF 1.0								
SUMMARY STATISTICS								
Adjusted R-Squared	0.748	0.812	0.791	0.773	0.910	0.902	0.890	0.868
Root Mean Squared Error	44.5	39.6	48.5	63.0	34.3	42.2	48.3	65.7
F-Statistic	54.2	155.9	137.3	123.4	90.8	166.1	145.6	110.8
Number of Observations	252	504	504	504	126	252	252	252

* Investor loans are included in this category.

III. FORECASTING FHA LOAN PERFORMANCE

The estimated econometric models for conditional claim rates and prepayment rates are used to simulate the history of loan performance and to develop projections of future loan performance under alternative economic scenarios. The simulation analysis is used to project the number of claims and prepayments over the historical period from 1979 through 1989 for specified levels of disaggregation of loan size, LTV, loan origination year and termination year. The forecast analysis develops conditional claim and prepayment rates for up to the first fifteen policy years after 1989 for each of the defined loan categories and for each loan origination year from 1976 through 1990³. Using different economic scenarios, the sensitivity of future conditional claim and prepayment rate can be evaluated.

A. Dynamic Simulation of Historical Claims and Prepayments

To evaluate the ability of the model to explain and forecast the conditional claim and prepayment rates, a dynamic simulation of the number of claims and prepayments was conducted across the historical period from 1979 through 1989. The simulation is dynamic in the sense that the number of claims and prepayments in a policy year are computed recursively from the computed number of loans surviving to the start of the policy year and the separate prediction of the conditional claim and prepayment rates for that policy year. The predicted conditional probability rates are multiplied by the number of loans that survived to the beginning of the policy year to compute the predicted number of claims and prepayments in that policy year. The sum of claim and non-claim terminations for each year is used to compute a projection of the number of loans that survive to the beginning of the next policy year. While, the conditional claim and prepayment rate models provide independent predictions of "conditional probability rates" in each year, the estimated numbers of claims and prepayments is determined dynamically through a recursive computation of surviving loans followed by "termination counts". In producing *ex-ante* forecasts to estimate the number of claim and non-claim terminations in future years to support the associated cash flows forecast analysis, this type of dynamic simulation is conducted. Therefore, it will be instrumental to evaluate the dynamic simulation performance using the *ex-post* forecast of the conditional claim and prepayment rates.

Predictive accuracy is determined by comparing the predicted numbers of claims

³In using the zero-one indicator variables for policy years one through fifteen it is not possible to directly project the conditional claim rates after the 15th policy year without making assumptions with respect the impact of additional indicator variables for the subsequent years. It is expected that conditional claim rates will be small and close to a steady state level by the 15th policy year so that projections after the fifteenth year are estimated using a declining trend from the 15th policy year to the 30th policy year.

MMI FUND ANALYSIS

and prepayments with the actual claims and prepayments across selected categories of loans. Differences between actual and predicted values have been aggregated across LTV, loan size, termination year and loan origination year. These summary statistics provide an indication of the model's predictive ability across specified loan category, loan origination years and termination years. Tables A.8 and A.9 below present the results of the dynamic simulation exercise for the conditional claim and prepayment rate model.

Table A.8

LOAN SIZE	LTV CATEGORY	DYNAMIC SIMULATION OF CLAIMS AND PREPAYMENTS FOR THE PERIOD 1979-89 Across loan Size and LTV Categories					
		CLAIMS			PREPAYMENT		
		ACTUAL	PREDICTED	ERROR	ACTUAL	PREDICTED	ERROR
	75-85%	13,790	14,680	-890	99,603	83,228	16,375
	85-90%	20,488	21,456	-968	104,732	96,895	7,837
	90-93%	25,137	23,639	1,498	92,983	93,341	-358
	93-95%	44,871	42,866	2,005	113,035	104,674	8,361
	95-97%	90,120	83,625	6,495	180,114	169,460	10,654
	> 97%	37,326	35,145	2,181	119,002	112,340	6,662
1		44,907	43,307	1,600	66,091	65,329	762
2		29,001	27,503	1,498	65,050	66,055	-1,005
3		31,434	28,722	2,712	87,824	80,192	7,632
4		31,448	28,454	2,994	97,862	94,970	2,892
5		29,803	28,094	1,709	102,856	92,050	10,806
6		47,041	43,257	3,784	181,444	175,238	6,206
7		18,098	22,075	-3,977	108,342	86,303	22,039
TOTALS		231,732	221,412	10,320	709,469	660,138	49,331

Table A.9

DYNAMIC SIMULATION OF CLAIMS AND PREPAYMENTS FOR THE PERIOD 1979-89 Across Loan Origination and Termination Year								
ORIG YEAR	TERM YEAR	CLAIMS			PREPAYMENT			ERROR
		ACTUAL	PREDICTED	ERROR	ACTUAL	PREDICTED	ERROR	
	79	-	-	-	580	459	121	
	80	1,020	876	144	2,430	1,526	904	
	81	3,725	2,744	981	3,349	2,480	-231	
	82	7,054	4,734	2,320	2,142	3,948	-1,806	
	83	13,270	10,212	3,058	31,452	39,146	-7,694	
	84	15,373	16,208	-835	22,203	22,029	174	
	85	21,548	17,006	4,542	32,759	43,744	-10,985	
	86	28,750	26,414	2,336	181,663	225,265	-43,602	
	87	39,931	41,434	-1,503	247,279	174,624	72,655	
	88	51,652	52,473	-821	100,999	75,541	25,458	
	89	49,409	49,310	99	84,613	71,377	13,236	
	79	18,470	20,047	-1,577	59,114	54,696	4,418	
	80	24,940	23,074	1,866	66,772	82,978	-16,206	
	81	27,704	19,071	8,633	68,231	99,267	-31,036	
	82	19,053	14,006	5,047	60,834	67,352	-6,518	
	83	43,156	49,465	-6,309	162,278	149,647	12,631	
	84	26,083	24,427	1,656	93,323	80,702	12,621	
	85	30,713	29,027	1,686	119,246	62,991	56,255	
	86	28,565	27,387	1,178	59,214	39,328	19,886	
	87	11,048	14,908	-3,860	20,457	23,178	-2,721	
TOTALS		231,732	221,412	10,320	709,469	660,138	49,330	

The model simulation across all loan size categories and across time predicts 96 percent of the actual number of claim and 93 percent of the number of prepayments. In general, the claims are well explained. For no LTV category, loan size category, termination year or origination year is the absolute difference between actual and predicted claims as great as 9 thousand. Prepayment results by origination and termination year are far less satisfactory (but also less important to determining the financial position of FHA). Prepayments are over-predicted by 44,000 (24 percent) in 1986 and under-predicted by 73,000 (29 percent) in 1987. Regarding origination year, prepayments of the 1980-81 books are over-predicted by 47,000 (35 percent), while prepayments of the 1985-86 books are under-predicted by 67,000 (43 percent).

The PD&R staff at HUD suggested that a reversion back to the low defaulting 1970s occurred in 1986, referring to some work reported by researchers at OMB. We see no reason why this should have occurred: the economic advantages of default that have been learned are unlikely to be unlearned. Further, no significant evidence for over-prediction of defaults on the post-1985 books of business come out of our simulations. Referring to Table A.8, claims on the 1986 book of business are under-predicted by 1,200 and those in 1987 are over-

predicted by 3,900.

Nonetheless, equations were re-estimated allowing for different responses on post-1985 books of business. The evidence was mixed. Simulations with the revised equations did reduce the 1987 overprediction by 1,000 but the 1986 underprediction was increased by 4,200. Thus we see no reason to believe that the basic proclivity to default for a given equity position has declined since 1985.

B. Forecasting Conditional Claim and Prepayment Rates

The models are used to forecast conditional claim and prepayment rates over the thirty-year term life of the mortgage under alternative economic scenarios in order to assess the reasonableness of the results and to determine the sensitivity of the projections to changes in select components of the economic forecasts.

In Table A.10 the forecasts of conditional claim and prepayment rates on the 1986-90 books of business are summarized for each of the first ten policy years (numbers above the step bar represent actual conditional claim rates for each origination year) and for the ultimate claim rate. These forecasts assume a base line forecast of 3.25 percent for constant quality house price appreciation, a 10 percent FHA contract rate, and an unemployment rate of 5.5 percent.

TABLE A.10

FORECAST OF CONDITIONAL CLAIM RATES 1986-90 Assuming Baseline Economics					
POLICY YEAR	1986	1987	1988	1989	1990
1	0.01%	0.01%	0.01%	0.02%	0.02%
2	0.51	0.39	0.46	0.50	0.47
3	1.88	1.13	1.46	1.55	1.42
4	2.31	1.57	2.13	2.06	1.90
5	1.50	1.70	1.91	1.85	1.72
6	1.51	1.56	1.70	1.64	1.53
7	1.22	1.25	1.39	1.35	1.26
8	0.94	0.98	1.10	1.07	1.00
9	0.76	0.80	0.93	0.91	0.84
10	0.62	0.65	0.75	0.74	0.68
ULTIMATE	12.03%	11.67%	13.60%	13.57%	12.57%

The results indicate that for baseline economic conditions the conditional claim rates are expected to remain high. The variability between the 1986 to 1990 books of business is associated more with the distribution in loans across LTV and loan size categories than with differences in economic conditions. The moderately low ultimate claim rate forecast for loans originated in 1987 (9.65 percent) follows

directly from the combined effect of favorable housing economic conditions in that year and the relatively low proportion of loans above 95 percent LTV. The marked upturn in predicted claim termination rates in 1988 and 1989 is attributable to the shift in loan distribution toward higher LTVs. The reversal in conditional claim rate projection for 1990 is associated with the expanded loan ceiling. Not only are loans just below the new ceiling expected to have lower claim rates than the claim experience of the largest loans categories used in our estimation, holding LTV constant, but these loans are required by law to have an incrementally lower LTV. The effective maximum LTV on for loans between \$101,250 and \$124,750 ranges from 95 to 96 percent.

Tables A.11 and A.12 show how the model forecasts conditional claim rates across the LTV categories and across the loan size categories using the 1990 loan origination year. Loan defaults are projected to rise for higher LTV ratios, with jumps occurring at 90 and 95 percent.

Table A.11

POLICY YEAR	1990 FORECAST OF CONDITIONAL CLAIM RATES BY LTV Assuming Baseline Economics							TOTAL
	<75%	75-85%	85-90%	90-93%	93-95%	95-97%	>97%	
1	0.02%	0.02%	0.01%	0.02%	0.02%	0.02%	0.02%	0.02%
2	0.22	0.21	0.23	0.35	0.45	0.70	0.71	0.47
3	0.87	0.81	0.79	1.10	1.40	1.95	2.02	1.42
4	1.23	1.14	1.07	1.56	1.88	2.53	2.64	1.90
5	1.05	0.96	0.93	1.41	1.78	2.27	2.39	1.72
6	1.37	1.25	0.66	1.41	1.64	1.86	1.98	1.53
7	0.95	0.86	0.73	1.07	1.31	1.58	1.69	1.26
8	0.77	0.69	0.41	0.86	1.03	1.30	1.40	1.00
9	0.39	0.35	0.37	0.66	0.90	1.15	1.26	0.84
10	0.53	0.47	0.32	0.34	0.73	0.95	1.05	0.68
ULTIMATE	6.92%	6.30%	5.38%	10.68%	11.94%	17.74%	19.34%	12.57%

When viewing the 1990 forecast across the loan size categories, there are significantly higher claim rates for the loans less than \$40,000 in 1990 nominal values. In the next higher loan size there is little variation in the conditional claim rate projections. Beginning in 1990 the loan ceiling was raised to \$124,750 with the added requirement of incrementally higher downpayment requirements. This results in a further drop in the projected conditional claim rate for this category of loans.

MMI FUND ANALYSIS

TABLE A.12

1990 FORECAST OF CONDITIONAL CLAIM RATES BY LOAN SIZE Assuming Baseline Economics									
POLICY YEAR	\$0-40K	\$40-60K	\$60-80K	\$80-100K	\$100-120K	\$120-140K	\$140-160K	\$160-180K	TOTAL
1	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%	0.02%
2	0.58	0.54	0.48	0.47	0.47	0.47	0.45	0.38	0.47
3	1.82	1.61	1.42	1.40	1.38	1.39	1.34	1.19	1.42
4	2.53	2.15	1.86	1.84	1.82	1.83	1.77	1.60	1.90
5	2.35	1.97	1.66	1.64	1.63	1.64	1.58	1.45	1.72
6	2.23	1.76	1.44	1.42	1.41	1.42	1.36	1.32	1.53
7	1.89	1.47	1.18	1.16	1.15	1.16	1.13	1.06	1.26
8	1.56	1.18	0.92	0.91	0.90	0.91	0.88	0.81	1.00
9	1.33	1.02	0.77	0.76	0.75	0.76	0.73	0.67	0.84
10	1.17	0.85	0.62	0.60	0.59	0.60	0.57	0.52	0.68
ULTIMATE	19.23%	15.37%	12.12%	11.89%	11.77%	11.48%	11.02%	9.66%	12.57%

It is valuable in reviewing the conditional claim rate forecast to determine the sensitivity of conditional claim rates to changes in the economic forecast assumptions. In particular, what impact would changes in house price appreciation, house price variability, FHA contract rates and unemployment have on future conditional claim rates? To answer this question, each variable is changed by a fixed percent and maintained at this level through out the term of the mortgage. The results are given in Table A.13. Note that a percentage point decline in house price appreciation or rise in unemployment increases the cumulative default rate by about 2 percentage points, while a 10 percent increase in house price dispersion raises default by 6 percentage points.

TABLE A.13

1990 FORECAST OF CONDITIONAL CLAIM RATES For Selected Changes in the Economic Variables				
POLICY YEAR	BASE LINE*	CGHP 2.25%	HP VAR +10%	UNEMPL 6.5%
1	0.02%	0.02%	0.015%	0.02%
2	0.47	0.49	0.48	0.55
3	1.42	1.51	1.45	1.65
4	1.90	2.07	1.97	2.20
5	1.72	1.92	2.03	1.99
6	1.53	1.75	2.20	1.77
7	1.26	1.47	2.32	1.46
8	1.00	1.18	1.95	1.15
9	0.84	1.01	1.77	0.97
10	0.68	0.83	1.50	0.78
ULTIMATE	12.57%	14.47%	18.63%	14.37%

* CGHP=3.25%, UNEMPL=5.5%

The projections for conditional prepayment rates are summarized for the baseline economic forecasts. In Table A.14 these projections indicate that prepayment is expected to be between 60 and 65 percent and that no significant variation in the

prepayment will be seen, given the stable forecast of interest rates through the term of all the mortgages.

TABLE A.14

FORECAST OF CONDITIONAL PREPAYMENT RATES 1986-90 Assuming Baseline Economics					
POLICY YEAR	1986	1987	1988	1989	1990
1	0.51%	0.25%	0.37%	0.46%	0.19%
2	3.75	1.03	1.52	1.25	1.09
3	2.69	1.74	2.32	2.10	2.04
4	3.16	2.47	2.86	2.74	2.73
5	2.44	2.45	2.82	2.73	2.69
6	2.13	2.16	2.50	2.44	2.38
7	1.79	1.82	2.09	2.05	2.01
8	1.58	1.67	1.90	1.87	1.91
9	1.71	1.75	1.98	1.96	2.00
10	2.36	2.42	2.75	2.73	2.79
ULTIMATE	61.53%	60.66%	60.44%	60.21%	60.66%

IV. CONCLUSIONS

The analysis of loan performance for FHA-insured loans supports the hypothesis that default and prepayment behavior can be explained largely by the borrowers' equity position associated with house price appreciation and the time path of mortgage interest rates since the loan was originated.

The analysis was conducted by pooling the time series of loan performance over policy years for individual specified categories of loan size, LTV and loan origination years and suggests that there is considerable variation in loan performance across these defined categories. With respect to LTV categories, there is a pronounced acceleration of default experience when the LTV exceeds 90 percent and a further, even sharper, increase when it goes above 95 percent. Evaluating the impact of changing loan size indicates that higher loan values yield a small but measurable reduction in default rates. The less the buildup in equity as measured through LTV and house price appreciation, the higher is the likelihood of default.

The analysis conducted at the national aggregate level was able to estimate the effects on default rates associated with regional economic stress that has resulted in depressed properties values for select areas during the 1980s. It is viewed that a major contributing factor to the variation in loan defaults regionally is due to the marked increase in the volatility in house price appreciation. An index of

MMI FUND ANALYSIS

house price dispersion was developed which showed the extent of the increase in dispersion in house price appreciation across major US Census Regions. It was found that the house price dispersion measured over time is directly linked to the observed increased propensity to default on FHA-insured loans.

The estimated models provided a basis to forecast the future probability of claim and non-claim termination for alternative economic scenarios. The projections are sensitive to assumptions about expectations for house price appreciation and the regional dispersion of future house price appreciation.

APPENDIX B: ACTUARIAL ANALYSIS**I. INTRODUCTION**

The purpose of the actuarial analysis was to assess the Fund's ability to withstand future losses from both its current portfolio of mortgages and future books of business. Specifically, we analyzed the Fund's value under alternative economic and policy assumptions by projecting future loan performance and the corresponding financial performance of the Fund. This appendix focuses on how the projections of loan performance were used to analyze the financial viability of the Fund.

In evaluating the Fund's value, we examined the Fund as an investor would evaluate the market value of a company. An investor estimates a company's value as the present value of its current business (investments) plus the present value of new business (investments) expected to be undertaken. Assuming FHA continues to insure loans, its value depends on both its current portfolio of loans and future books of business. Although the methodology used to analyze the value of current and future business is very similar, we analyzed the two books separately to isolate the impact of future policy changes on the Fund's value. Below the general methodology for estimating future losses is described. In the following sections, we describe the application of this methodology to analyzing the current portfolio and future business.

II. METHODOLOGY

To analyze future changes in the Fund's equity, we developed a model to project future cash flows. This model incorporates projections of loan performance and information about the insurance in force to project the Fund's major cash flows. The discounted value of these cash flows equals the current value of changes in the Fund's equity.

Future cash flows are projected using the forecasts from the econometric models discussed in Appendix A. These models predict conditional claim and prepayment rates for each cross sectional category of loan-to-value and loan size on an endorsement year / post-endorsement year basis. Because of their construction, these models predict claim rates only through the 15th post-endorsement year and prepayment rates through the 10th year. Claim rates after the 15th year were assumed to decline at 5% per year from the 15th year rate. Prepayment rates after the 10th year were assumed to move towards a steady state conditional rate of 4.5%.

Based on these termination rates, the major components of cash flow were

MMI FUND ANALYSIS

projected into the future. The cash flow components analyzed are:

o	premiums,	(cash inflow)
o	net losses associated with claims,	(cash outflow)
o	refunded premiums,	(cash outflow)
o	administrative expenses, and	(cash outflow)
o	distributive shares.	(cash outflow)

Each component was projected for each cross section of loan-to-value and loan size and then aggregated to the endorsement year and fiscal year level. The following section discusses these cash flow components. First, we provide definitions of key terms used in the analysis.

- o Insurance-in-force: the unamortized value of the surviving mortgages insured by FHA.
- o Average Outstanding Balance (AOB): the principal balance outstanding divided by the original mortgage amount. The AOB is calculated based on the term of the mortgage, mortgage interest rate, and the type of the mortgage.
- o Conditional Claim Rate: the number of claims divided by the number of surviving loans.
- o Loss Ratio: the dollar loss incurred on claims divided by the claim amount.
- o Conditional Prepayment Rate: the number of prepayments divided by the number of surviving loans.
- o Refund Rate: the portion of the premium that is refunded when a loan is prepaid. The refund rate is typically defined as the dollar refund per \$1000 of the mortgage value at origination. (e.g., the refund in the first year is \$3.43/\$1000 of the original mortgage value.)

A. Premium

The insurance premium is the primary revenue collected by the Fund. If the Fund's mortgages are priced to be premium sufficient, the insurance premiums collected and interest earned on them will cover all costs incurred in insuring the mortgages. During the period being analyzed, the insurance premium was structured in two ways. Through September 1, 1983 the mortgage premium was collected on a monthly basis as a percentage of the outstanding principal balance for the period. After September 1, 1983 the premium was collected at the time of origination. We assumed for this analysis that the annual premium policy was in

effect through the end of fiscal year 1983.

In calculating the premiums collected on loans endorsed through 1983, we assumed a premium of 0.5% of the mortgage's average outstanding balance for the year. Thus, the mortgage premium collected during year i equals the average outstanding balance of insurance-in-force during year i times the annual premium.

$$\text{Premium}_i = \text{Insurance-in-force}_i \cdot \text{AOB}_i \cdot 0.5\%$$

In analyzing loans endorsed after 1983, we assumed FHA collected an up-front premium rate of 3.8% of the mortgage origination value for 30-year mortgages and 2.4% for 15-year mortgages. Thus, the mortgage premium collected on loans endorsed after 1983 equals the origination mortgage amount times the appropriate insurance premium.

$$\text{Premium}_i = \text{Origination Amount}_i \cdot \text{Mortgage insurance premium}$$

Although FHA technically receives this premium up-front, the mortgagor is allowed to finance the premium and, therefore, the portion of the premium that is financed is included in the initial principal value of the mortgage. The original mortgage amount used above in calculating the premium excludes financed premium. However, when a mortgage defaults, FHA must pay a claim that consists of the unamortized portion of both the mortgage and financed premium. Therefore, FHA effectively collects very little premium on mortgages that default.

B. Losses Associated with Claims

Losses due to claims comprise the largest expense to the Fund in the early years of mortgages' lives. When a mortgage defaults, the lender files a claim with FHA. After FHA pays the claim, it receives the foreclosed property and must sell the property to recoup its loss. These events result in two separate cash flow: 1) the cash outflow of the claim payment, and 2) the cash inflow of the net proceeds received in selling the claimed property. Because there is typically a lag between the time of the claim payment and the receipt of proceeds from property disposition, we have analyzed these two cash flow components separately.

The claim payment consists primarily of the outstanding balance at the time of the default. In addition, FHA may pay for additional costs incurred by the bank on the defaulted mortgages.

MMI FUND ANALYSIS

$$\text{Claim Payment}_i = \text{Insurance-in-force}_i * \text{AOB}_i * \text{Claim Rate}_i * (1 + \text{Bank Costs})$$

where the Bank Costs equal the average costs incurred by banks per dollar of outstanding balance.

In our analysis, we assumed that the primary cost associated with claims was the interest income lost by the bank between the time at which the mortgage defaults and the claim is paid. From a previous analysis performed during the FY1988 Audit, we found that the average lag between default and claim payment is 15.6 months. Thus, the additional bank costs were estimated as interest income lost on the outstanding balance of the mortgage for 15.6 months.

Net proceeds were estimated by multiplying the claim payment by one minus the loss ratio. However, because property sales typically lag claim payments by 7.8 months¹, we allocated the net proceeds cash flow to the appropriate fiscal year so that proceeds received in fiscal year i are calculated as follows:

$$\begin{aligned} \text{Net Proceeds}_i &= (7.8/12) * \text{Claim Payments}_{i-1} * (1 - \text{Loss Ratio}) \\ &+ (4.2/12) * \text{Claim Payments}_i * (1 - \text{Loss Ratio}) \end{aligned}$$

C. Refunded Premiums

With the initiation of the up-front premium, FHA began refunding a portion of the premium when borrowers prepaid their mortgages. The refund rate depends upon the time at which the mortgage is prepaid.

$$\text{Refund dollars}_i = \text{Insurance in Force}_i * \text{prepayment rate}_i * \text{refund rate}_i$$

The refund rates used in the analysis of the existing portfolio are those currently used by FHA.² In the analysis of new business, the refund rate depends on the policy analyzed. Section III will provide details such as the refund rate assumed for each of the policy options.

¹This figure represents the average months on hand of property. It was estimated during the Fiscal Year 1988 Financial Audit of the FHA.

²Herzog, Thomas, "Introducing the Single Premium Plan", *Mortgage Banking*, April 1984.

D. Administrative Expenses

In addition to estimating cash flows associated with loan performance, the model also projects administrative costs incurred in insuring mortgages. Administrative expenses are calculated based on the outstanding balance of the insurance-in-force over the period. The factor used in this analysis is 0.094%.³

E. Distributive Shares

Distributive shares were designed to allow FHA to return a portion of the insurance premium to the insured borrower if the business for that endorsement year was more profitable than expected. Specifically, if the premium collected is more than sufficient to cover the costs of insuring the loans, a portion of the premium in excess of the costs can be returned to the borrower through a distributive shares payment. In determining the distributive share, there are two major questions: (1) is the book profitable enough to pay a distributive share, and (2) how much of the profit should be returned to the borrower relative to how much should be held as a reserve for unprofitable years?

In this analysis, we assumed that FHA will continue to pay distributive shares to the same books of business and at the same rate that it is currently paying. Table B.1 presents the distributive share rates assumed in our analysis.

³Middaugh, David, "Analysis of the Insurance Reserves as of September 30, 1988", Department of Housing and Urban Development.

Table B.1

Distributive Shares Allocation FY 1988
by Endorsement Year
(Dollars per \$1000 of Original Mortgage Amount)

Endorsement Year	30-Year Mortgages	15-Year Mortgages	30-Year GPMs
1970	77.72	0.00	0.00
1971	28.81	0.00	0.00
1972	70.15	0.00	0.00
1973	40.48	0.00	0.00
1974	62.18	0.00	0.00
1975	24.46	0.00	0.00
1976	35.68	0.00	0.00
1977	47.73	0.00	47.26
1978	34.39	20.69	33.96
1982	0.00	17.94	0.00
1983	0.00	20.10	0.00

Mortgages that were endorsed prior to 1970 and whose term is greater than 20 years receive the entire premium paid.

Source: The Calculation of Distributive Shares under the Mutual Mortgage Insurance Fund, Herzog and Middaugh, May 1988.

Although FHA has not determined distributive shares for endorsement years after 1984, we estimated that these books will be unprofitable and therefore, FHA will not pay distributive shares to these books.

Distributive shares are paid upon prepayment or maturity of the loan. Thus, we use the projected prepayment rates to estimate the volume of distributive shares payments.

III. ANALYSIS OF THE CURRENT PORTFOLIO OF MORTGAGES

In analyzing the economic value of the Fund, we first examined those loans that FHA currently has in its portfolio. The Fund's current equity less the future value of losses expected to be generated by this business represents the Fund's value assuming FHA stops insuring new business. This value relative to the current insurance-in-force provides a measure of the Fund's financial strength. To test the Fund's ability to withstand adverse economic conditions, we analyzed the financial performance of the current portfolio under various economic scenarios.

The current portfolio of loans consists of various terms and types of mortgages. To analyze the current portfolio, we grouped the loans into three major categories: (1) 30-year fixed payment mortgages, (2) 15-year fixed payment mortgages, and (3)

MMI FUND ANALYSIS

graduated payment mortgages. The 30-year mortgage category includes both fixed and adjustable rate mortgages as well as loans with terms ranging from 16 to 30 years. The majority of these loans, however, are 30-year fixed rate mortgages (less than one percent are adjustable rate mortgages). Insurance in force as of the end of 1988 is presented below.

Table B.2

Endorsement Year	Insurance in Force End of Fiscal Year 1988 (Unamortized Value in Million Dollars)		
	30-year Mortgages	15-year Mortgages	Graduated Payment Mortgages
Pre 1975	\$20,184		
1975	\$2,204	\$3	--
1976	\$2,898	\$5	--
1977	\$4,327	\$4	\$5
1978	\$5,852	\$4	\$940
1979	\$7,116	\$5	\$3,919
1980	\$5,452	\$6	\$2,542
1981	\$2,498	\$7	\$565
1982	\$1,073	\$9	\$230
1983	\$9,094	\$926	\$1,169
1984	\$5,041	\$453	\$619
1985	\$10,184	\$931	\$669
1986	\$46,251	\$3,895	\$744
1987	\$62,630	\$3,718	\$651
1988	\$34,197	\$650	\$301
Total	\$219,008	\$10,616	\$12,354

In analyzing the financial performance of these loans, we used the methodology described in the previous section. However, slight modifications were made in analyzing the different types of loans. These are described below.

- o Graduated Payment Mortgages: The primary difference between the graduated payment and other 30-year mortgages is the payment plan used by the GPMs. Payment plans for GPMs actually increase the mortgage value outstanding for the first 5 to 10 years of the mortgage. Increasing rather than decreasing mortgage values impact the loan performance and cash flows in two ways: (1) an increasing mortgage obligation can result in negative equity during the early years of the mortgage, thus increasing the risk of default; and (2) an increasing mortgage obligation increases the potential claim amount that FHA must pay if the mortgage defaults.

In analyzing the claim and prepayment rates of GPMs, we found that in aggregate the termination rates of GPMs are very similar to those of the other 30-year mortgages. Therefore, we applied the aggregate predicted

MMI FUND ANALYSIS

claim and prepayment rates of the 30-year mortgages to the graduated payment mortgages.

In predicting the claim payments associated with GPMs, we used an outstanding balance factor for a 5-year 7.5% annual growth GPM (i.e. the mortgage payment increase yearly by 7.5% for 5 years).

- o 15-Year Mortgages: As for the GPMs, the major difference of the 15-year mortgages was their payment plan. Again, because we did not model the 15-year mortgages separately, we did not directly capture the impact of an accelerated reduction in principal associated with 15-year mortgages. In analyzing them more closely, we found that these mortgages tend to have claim rates approximately 2/3 of their 30-year counterparts. Therefore, we reduced the predicted claims for 30-year mortgages by 1/3 in predicting claims for the 15-year mortgages. Prepayment rates were assumed to be the same as the 30-year mortgages.

In predicting the claim payments and associated losses for the 15-year mortgages, we applied an outstanding balance factor commensurate with the 15-year term of the mortgage.

- o Mortgages endorsed prior to 1975: To analyze these loans, we used FHA's most recent survivorship tables for 30-year mortgages.⁴ These mortgages are sufficiently seasoned so that economic conditions will not affect their performance significantly.

IV. ANALYSIS OF THE FUTURE PORTFOLIO OF MORTGAGES

In analyzing possible policy options, we focused on those policies that would enable FHA to improve the financial position of the Fund. Thus, the new books of business must at least break even, if not provide a surplus to increase the Fund's value. To reach a break-even point, FHA has two policy initiatives: (1) increase revenues by raising the required premium or (2) lessen losses incurred by the Fund by reducing the risk of its loans.

The policy options we analyzed focused on these initiatives. In analyzing them, we examined their impact on the financial performance of the Fund as well as on the risk of the new business. As discussed in Appendix A, a key factor that explains the risk of default is the loan-to-value ratio of the loan. FHA's current policy enables the borrower to finance the premium and closing costs on the loan. Any

⁴Survivorship and Decrement Tables for HUD/FHA Home Mortgage Insurance as of December 31, 1988, Herzog and Stasulli, January 1989.

MMI FUND ANALYSIS

policy that changes the amount of the premium and/or closing costs that can be financed will affect the performance of these loans.

To analyze the impact of the policies on the initial loan equity, we estimated the range of true LTVs under each of the policy scenarios. The true LTV was defined as the total mortgage amount less the value of the premium refund divided by the property value.

$$\text{"True LTV"} = \frac{\text{mortgage amount} - \text{premium refund}}{\text{property value}}$$

The value of the premium refund is deducted from the mortgage liability because it represents equity to the borrower. This equity, however, decreases rapidly as the refund rate declines over time. In measuring the initial true LTV, the refund's equity value in the years of high default risk was used.

Based on the new LTV ranges under each of the policies, we allocated the loans to the appropriate LTV categories. The econometric models specified for each of these categories were used to project claim and prepayment rates under each of the policy scenarios. The specific assumptions regarding premiums, refund rates, and required downpayments under each of the policy scenarios follow.

- o FHA's Current Policies: Under current policies, all of the 3.8% premium and closing costs assumed to equal 3.0% of the mortgage less the financed premium can be financed. To calculate the range of LTVs, we assumed the net premium to be approximately 1.8% (i.e. 3.8% premium minus 2.0% refund). Therefore, an FHA defined "97% LTV" loan would actually have an LTV of approximately 101.7%.
- o Increase the Premium: Under a policy in which FHA increases the premium yet still allows all of it to be financed, initial LTVs will increase. For this analysis, we assumed that the refund rates under this policy are the same percentage of the total premium as under the current policies (e.g. the refund rate in the middle of the 3rd and 4th year is approximately 53% of the premium). If, for instance, the premium was increased to 5.5%, the net premium would be 2.6% (5.5% less the refund of 5.5% times 53% -- 2.9%) and the actual LTV of a 97% FHA defined LTV would be approximately 102.5%. Under this policy, we assumed that all borrowers would finance the increase in the premium.
- o Raise the Required Downpayment: Such a policy restricts the amount of financing allowed on the property value, insurance premium, and closing costs. Of course, the biggest impact is on the required downpayment on the property. For instance, a policy that requires the minimum up-front borrower cash outlay to be 7% -- the maximum FHA

MMI FUND ANALYSIS

defined LTV is 93% -- translates to a true LTV of approximately 97.5%. Although the performance of the loans improves dramatically under this policy, FHA continues to pay claims on the financed portion of the premium, and thus, effectively collects a very small premium on those loans that default.

- o Restructure the Premium: Under a policy in which FHA requires a small up-front premium in cash and monthly premium payments, the initial LTV is reduced because none of the premium is financed. The true LTV of a 97% FHA-defined LTV is approximately 100%.⁵ We have assumed, alternatively, that when possible, borrowers simply increase the loan on their property to finance the cash premium. In addition, because the borrower is required to make monthly premium payments, the present value of the mortgage liability increases. Correspondingly, loans do not perform as well under this policy as they do under the previous policy, although the initial LTVs are very similar. The financial performance of the business under this policy is slightly better because the premium has effectively been increased.
- o Set Risk-based Premiums: This policy assumes that all borrowers pay the current up-front premium of 3.8 percent and that those borrowers with LTVs above 90 percent pay an annual premium for a set number of years based on the loan's initial FHA-defined LTV. As under the current policy, the up-front premium can be financed, and thus, the initial true LTV of the loans does not change. However, the mortgage liability increases slightly for loans on which the annual premium is paid. Therefore, loan performance is slightly worse under this policy compared to the current policy. However, the additional premiums collected enables the financial performance of the business to be much better.
- o Increase the Current Loan Ceiling: Under this policy we assumed there is no change in the downpayment requirements of the loans, except that the minimum downpayment on the portion of the loan exceeding \$100,000 is 10%.

Under all but the last policy we assume that loan demand was \$50 billion based on the current loan ceiling of \$125,000. That is, even when the cash requirements to the borrower changed, the demand for FHA-insured loans did not.

⁵There is no premium refund under this policy.

APPENDIX C: MMI FUND DATA ANALYSIS

This appendix provides an overview of the MMI Fund analysis performed in the initial phase of this project. This analysis provides a historical statistical database of FHA-insured mortgages and creates a database for the claim rate and prepayment rate analysis and cash flow analysis. This involved extracting the data from the FHA's A-43 database and categorizing the data into subsets based on mortgage characteristics. When there were enough comparable mortgages, values for missing data were estimated. Additionally, disaggregated data were analyzed to better understand the data. In this appendix, the steps involved in developing the database are described.

I. AN OVERVIEW OF THE A-43 DATABASE

The A-43 database contains detailed information on over 11 million loans insured by the FHA Mutual Mortgage Insurance (MMI) Fund. The types of mortgages in the database include Fixed Rate, Adjustable Rate, and Graduated Payment Mortgages. Although most of the mortgages in the database are 30-year mortgages, there are also a significant number of 15, 20, and 25-year mortgages. The information on whether the mortgage has claimed, been prepaid, or remains active is maintained in the A-43 database.

When a new loan is endorsed, a loan record is entered into the database. There are over 100 variables in the A-43 database that contain information about each loan. These include the important dates at every stage of the life of the mortgage, case numbers, profile information about the borrower, and a variety of other information. For the analysis, the following key variables were selected:

- o Date of Loan Origination
- o Loan-to-Value (LTV) Ratio
- o Mortgage Amount
- o Type of Mortgage (i.e. Fixed Rate, Adjustable Rate, Graduated Payment)
- o Term of the Mortgage (Number of Months)
- o Status of the Loan ("A" = Active, "C" = Termination due to Claim, and "T" = Termination due to Loan Prepayment)
- o Address of the Property

If there is a claim on the mortgage or the mortgage was prepaid, this information is entered on the loan record status. This information is transferred in from databases that maintain information on loan terminations. If the mortgage has terminated, our analysis will also include these variables from the A-43 database loan record:

- o Date of Loan Termination
- o Claim Amount

o Profit or Loss to the FHA on Resale of the Property

These variables provide the key information used for the claim rate and prepayment rate analysis and the cash flow analysis.

II. CATEGORIZATION OF THE DATA

The 11 million loan records were condensed into a categoric database to make it more manageable. The initial step was a division of all loans into separate loan amortization years, loan size categories, LTV ratio categories, loan termination years, loan types, loan terms, and states (locations of the properties). The state data were aggregated to a regional level, based on the ten HUD regions. The regional data were used to analyze the differences in the amount of business and the loss rates for different areas of the country. For the claim rate and prepayment rate analysis, the data were aggregated to the national level based on the following categories:

o	Years of Loan Amortization	(15 categories)
o	Years of Loan Termination	(15 categories)
o	Loan-to-Value Ratio	(8 categories)
o	Loan Size	(8 categories)
o	Type of Loan	(3 categories)
o	Term of Loan	(2 categories)

Since a loan cannot claim or be prepaid prior to its amortization, there are only 120 Amortization Year and Termination Year combinations (1975: 15 termination years, 1976: 14, ... , 1989: 1). The maximum possible number of categories is $46,080 = 120 \times 8 \times 8 \times 3 \times 2$. In the final analysis, there are fewer categories because of the incomplete distribution to all possible loan categories when there are few loans. For example, there were no Graduated Payment Mortgages (GPMs) prior to 1977.

A. Years of Initial Loan Amortization

The years of loan origination chosen for the analysis were Fiscal Years 1975-89, making 15 categories. The date of loan amortization is the date when the mortgage officially begins. The first payment of principal and interest is made one month later. The fiscal calendar was chosen rather than the standard calendar year to remain consistent with the FHA's accounting statements. This consistency eased the process of generating the data for the cash flow analysis.

The amortization date was chosen rather than the endorsement date because the time between the date the loan begins (amortization date) and the date that the Commissioner officially endorses the loan (endorsement date) can be significant. During the periods of high volume in 1986 and 1987, this lag time was especially significant. A sample of loans amortized in 1987 showed that the average time

between loan amortization and endorsement was 2.5 months, with a standard deviation of 3 months. Thus, a significant number of loans were not officially endorsed until over 6 months after amortization. On several occasions, borrowers defaulted on their loans before the commissioner's official endorsement.

B. Years of Loan Termination

The year of loan termination is the fiscal year in which a claim is paid by the FHA or a borrower prepays the loan. An important factor in the analysis is determining the factors that lead to the loan claim or loan prepayment. By separating each loan termination year from 1975 to 1989, the key economic changes in those years were isolated.

C. Loan-to-Value (LTV) Ratio Categories

The LTV ratios were separated into eight categories. This categorization permitted analysis of the relation between the mortgage downpayment and the probabilities of mortgage claim and prepayment. The percentage of loans for each of the LTV ratio categories for each fiscal origination year are shown in Table C-1:

Table C-1: Distribution of Loans by LTV Ratio Category

Fiscal Year	LTV Ratio Categories							Inventor
	30-75%	75-85%	85-90%	90-93%	93-95%	95-97%	97-100%	
1975	3.1%	4.7%	10.7%	13.1%	14.9%	32.3%	11.6%	7.5%
1976	2.9	3.7	8.1	13.0	18.3	35.3	12.1	6.9
1977	2.8	4.3	9.2	15.9	19.6	32.6	9.6	6.0
1978	3.2	4.3	8.3	15.3	18.1	35.5	8.6	6.6
1979	4.9	6.3	11.3	21.9	14.9	29.6	6.6	7.0
1980	8.2	9.7	18.1	16.4	13.2	23.0	2.8	8.6
1981	8.9	11.7	19.1	10.4	13.3	20.9	2.0	13.7
1982	13.8	13.4	14.8	10.2	13.3	18.5	1.3	14.7
1983	15.1	13.4	14.4	11.3	13.8	17.7	1.6	12.8
1984	10.4	6.0	12.5	11.0	13.1	22.3	7.4	17.5
1985	10.7	8.9	11.3	11.1	13.8	22.2	2.8	19.0
1986	11.8	10.6	11.5	10.5	12.9	23.2	3.5	15.8
1987	11.3	11.1	10.2	9.9	12.0	28.0	4.2	13.4
1988	5.9	5.9	9.4	11.4	16.1	35.8	6.9	8.7
1989	5.4	5.0	10.7	11.9	16.8	37.3	7.2	5.7
TOTAL	8.7	8.5	11.6	12.3	14.5	27.8	5.2	11.5

D. Loan Size Categories

The loan sizes were separated into eight categories in an attempt to distribute evenly the number of mortgages. As house prices have appreciated from 1975 to 1989, the loan size break points have each increased along with the national rate

MMI FUND ANALYSIS

of Constant-Quality House Price inflation. Table C-2 shows the upper limits of the loan size categories for each amortization year:

Table C-2: Loan Size Categories

Fiscal Year	National Constant- Quality House Price Appreciation	Loan Size Categories (Upper Limits)						
		1	2	3	4	5	6	7
1975	n/a	\$16,085	\$19,302	\$22,519	\$25,736	\$28,953	\$33,368	\$45,000
1976	8.43%	\$17,442	\$20,930	\$24,419	\$27,907	\$31,395	\$36,372	\$45,000
1977	9.44%	\$19,089	\$22,907	\$26,723	\$30,543	\$34,360	\$41,996	\$45,000
1978	13.87%	\$21,738	\$26,085	\$30,433	\$34,780	\$39,128	\$47,823	\$60,000
1979	15.01%	\$25,080	\$30,000	\$35,000	\$40,000	\$45,000	\$55,000	\$67,500
1980	11.37%	\$27,862	\$33,411	\$38,979	\$44,548	\$50,116	\$61,253	\$67,500
1981	9.86%	\$30,388	\$36,705	\$42,823	\$48,941	\$55,058	\$67,293	\$90,000
1982	9.70%	\$32,332	\$38,798	\$45,269	\$51,731	\$58,198	\$71,130	\$90,000
1983	1.70%	\$32,381	\$39,457	\$46,034	\$52,610	\$59,186	\$72,339	\$90,000
1984	4.03%	\$35,505	\$42,606	\$49,707	\$56,808	\$63,909	\$78,112	\$93,420
1985	3.59%	\$36,779	\$44,135	\$51,691	\$58,847	\$66,203	\$80,914	\$93,420
1986	2.92%	\$37,852	\$45,423	\$52,993	\$60,363	\$68,134	\$83,275	\$93,420
1987	2.39%	\$38,757	\$46,509	\$54,260	\$62,012	\$69,783	\$85,286	\$93,420
1988	1.04%	\$39,160	\$46,992	\$54,824	\$62,656	\$70,487	\$86,151	\$105,098
1989	2.05%	\$39,964	\$47,957	\$55,950	\$63,943	\$71,936	\$87,922	\$105,098

Since Fiscal Year 1984, the 3.8 percent premium could be financed with the mortgage; therefore, the loan size categories since FY 1984 have all been multiplied by 1.038. The upper limit of loan size category 7 is the FHA loan ceiling. Additionally, there is a loan size category 8, which includes all loans that exceed the official FHA ceiling. In certain cases, the closing costs may also be borrowed. If the mortgage amount equaled the FHA ceiling and the premium and closing costs were financed, the loan would fall into loan size category 8.

E. Type of Mortgage

There are three types of mortgages in the MMI Fund:

- o Fixed Rate Mortgages (FRMs)
- o Adjustable Rate Mortgages (ARMs)
- o Graduated Payment Mortgages (GPMs)

The ARM program originated in July 1984. This program comprises a small percentage of the FHA business. In 1987, the year with the largest percentage of ARMs, this program accounted for approximately 4 percent of the insured mortgages. The advent of the ARM program is far too recent to allow econometric analysis. ARMs have simply been left with FRMs for the purposes of analysis.

GPMs accounted for approximately 7 percent of the loans endorsed between 1975 and 1989, but less than 0.5 percent of loans amortized in Fiscal Year 1989.

F. Term of Mortgage

The term of the mortgage is the period of time from the date of loan amortization until its maturity. Most of the mortgages in the MMI Fund are 30-year mortgages. The 15-year mortgages were separated out. The 20 and 25-year mortgages were grouped in with the 30-year mortgages. There were also a few mortgages with unreasonable mortgage terms (2 months, for example). These mortgages, probably the result of data errors in the A-43 database, were also grouped in with the 30-year mortgages. Table C-3 shows the percentage of non-GPM mortgages by loan term for each amortization year:

Table C-3: Distribution of Mortgages by Term

<u>Fiscal Amortization Year</u>	<u>30-Year Mortgages</u>	<u>25-Year Mortgages</u>	<u>20-Year Mortgages</u>	<u>15-Year Mortgages</u>	<u>Other Terms</u>
1975	89.6%	7.1%	2.7%	0.4%	0.2%
1976	90.6	6.6	2.3	0.3	0.2
1977	91.3	6.2	2.0	0.2	0.3
1978	92.1	5.9	1.5	0.2	0.3
1979	91.5	6.6	1.5	0.2	0.2
1980	92.4	5.5	1.7	0.3	0.1
1981	93.7	3.9	1.7	0.4	0.3
1982	91.3	3.7	2.9	0.7	1.4
1983	86.6	2.3	2.1	7.6	1.4
1984	87.9	2.7	1.6	7.1	0.7
1985	88.4	1.3	1.0	8.7	0.6
1986	87.6	1.6	1.0	9.6	0.2
1987	87.1	3.4	1.0	7.8	0.7
1988	91.3	1.4	0.8	4.8	1.7
1989	93.0	1.0	0.8	3.4	1.8
1975-82	91.6	5.9	2.0	0.3	0.3
1983-89	88.7	2.1	1.1	7.2	1.0

The 15-year mortgages, which were trivial prior to 1983, have averaged 7.2 percent of FRMs since then. The 25-year mortgages, which were common in the late 1970's, are used much less often today.

III. ADJUSTMENTS TO THE DATA

Close examination of the A-43 database revealed significant data problems. Certain loan records contained missing data, while others contained data that were unreasonable (such as the loan with the 2-month term). Rather than deleting all of the loan records with potentially erroneous data, estimation techniques were used wherever possible. Given a significant amount of data in similar categories, interpolation techniques were used to estimate the values for missing or unreasonable values. Such values relate to claim amount and LTV ratio. Corrected data were estimated using other data from the same loan categories:

A. Estimating Missing Claim Dollars

The claim amount is the dollar amount paid to the bank on a defaulted loan in exchange for the deed to the property. Data on loan terminations are transferred into the A-43 database from another FHA database. It appears that these data are not always transferred. Occasionally, A-43 database loan records contain information that there has been a claim on the loan, but the information about the size of the claim was missing. On other occasions, the values for these variables were unreasonable.

A common problem is the failure of the information on the profit or loss on the resale of the property to get transferred to the A-43 database. Especially in the last few years, there are a significant number of loan records with claim amounts but without information on the resale of the property. Therefore, in our calculations of the loss ratios, only the loans with data on the loss (or profit) are included. This method gives the most accurate figures given the available data, but the loss ratios are essentially based on a sample of loan records.

1. Unreasonable Claim or Profit/Loss Dollars

In the analysis, the dollar amounts on foreclosed loans were considered "unreasonable" under the following criteria:

- o The loss on the resale of the property exceeded nine tenths of the claim amount
- o The profit or loss on resale of the property exceeded the original amount of the loan
- o The claim amount was less than zero
- o The claim amount exceeded twice the original mortgage amount

These broad standards were designed to correct only the data that seemed especially improbable. From 1975 to 1982, 0.8 percent of all loans were corrected because their data were unreasonable under these criteria. From 1983 to 1989, data for only 0.1 percent of all loans were re-estimated because of these standards.

2. Correcting Claim Dollars

To correct the loan records with missing and unreasonable claim amounts, the claim amount was calculated based on the average ratio of the claim amounts to the mortgage amounts for each loan category. For example, suppose the loan category consisted of loans that:

- o Were amortized in 1987
- o Claimed in 1988
- o Were in the smallest loan size category
- o Had LTV ratios of 75-85 percent

o Were 30-year fixed rate mortgages

Suppose that one of these loans had claimed and was missing the claim amount, but the other nine loans in the loan category, had this information:

<u># of Loans</u>	<u>Average Claim Amount</u>	<u>Average Mortgage Amount</u>	<u>Claim to Mortgage Ratio</u>
9	\$36,000	\$30,000	1.2
1	(missing)	\$20,000	n/a

Using the ratio (claim amount divided by mortgage amount) of 1.2 from the loan records with the data, the claim amount for the loan with missing data is estimated:

<u># of Loans</u>	<u>Average Claim Amount</u>	<u>Average Mortgage Amount</u>	<u>Claim to Mortgage Ratio</u>
9	\$36,000	\$30,000	1.2
1	\$24,000	\$20,000	1.2

Our analysis showed that the ratio of claim amounts to mortgage amounts is stable within specific loan categories. If all loans with claims in a specific loan category had missing claim amounts, the claim amounts were assumed to be 20 percent greater than the mortgage amounts. This rate reflects an average ratio of claim amounts to mortgage amounts.

B. Estimating Missing LTV Ratios

The A-43 database contains records for loans dating as far back as 30 years. The reliability of the older data had to be considered in choosing the years of data that would be suitable for the analysis. The Loan-to-Value (LTV) ratio is a critical component of the analysis, and it would have been problematic to include years with a large proportion of loans missing their LTV ratios. With a limited number of records with missing LTV ratios, the values can be estimated from records with LTV ratios. With too many missing values, this is not a reasonable procedure. Table C-4 shows the percentages of loan records with missing data on the LTV ratio.

Table C-4: Percentage of Loans with Missing LTV Ratios

<u>Fiscal Year</u>		<u>Fiscal Year</u>	
1974	63.7%	1982	17.3%
1975	20.1%	1983	20.2%
1976	20.2%	1984	2.8%
1977	12.5%	1985	1.1%
1978	17.5%	1986	0.3%
1979	23.1%	1987	0.1%
1980	12.0%	1988	0.1%
1981	27.4%	1989	0.5%

MMI FUND ANALYSIS

Due to the excessive number of loan records with missing LTV ratios in 1974 (and earlier), only loans originating in Fiscal Years 1975 - 1989 were selected for the analysis. This subset contains approximately 6.5 million loan records. In 1984, the percentage of loan records with missing LTV ratios dropped significantly.

As demonstrated in Table C-4, a significant number of loan records are missing data for the LTV ratio. For all loans amortized between 1975 and 1983, 18.8 percent of the loans had missing data on the LTV ratio, whereas between 1984 and 1989, only 0.5 percent are missing. Additionally, a few records contained LTV ratios beyond the FHA's allowable limits. Loan records with LTV ratios "out of range" constituted less than 0.2 percent of all loans. For the analysis, these ratios were treated as missing.

The information necessary to calculate the LTV ratio -- home value -- is not included in the A-43 database. Thus, the missing LTV ratios had to be estimated. This estimation procedure maintained the existing distribution of the LTV ratios in each loan category for active, prepaid, and claimed mortgages. The mortgages with missing LTV ratios were redistributed to the existing LTV ratio categories based on the percentage of loans in each existing category. The following hypothetical example demonstrates this redistribution. Suppose the loan category consisted of loans that:

- o Were amortized in 1975
- o Terminated or were still active in 1976
- o Were in loan size category 7
- o Were 30-year fixed rate mortgages

Suppose that 1,286 loans were distributed among 4 of the LTV ratio categories in the following way:

Status	LTV Ratio Category				
	75-85%	85-90%	90-95%	95-99%	Missing
Active	100	200	300	400	100
Prepaid	20	20	20	20	20
Claimed	0	10	20	30	6

The loan records with missing LTV ratios would be redistributed based on the percentage of all loans within each loan status. The result would be:

Status	LTV Ratio Category				
	75-85%	85-90%	90-95%	95-99%	Missing
Active	110	220	330	440	0
Prepaid	25	25	25	25	0
Claimed	0	11	22	33	0

This method maintains the percentage distribution of loans into the LTV ratio categories for each loan category and loan status. By maintaining the distribution of each loan status, the relation between the LTV ratio and the probabilities of

Price Waterhouse
C-8

claim or prepayment was maintained.

C. Elimination of Erroneous Loan Records

Despite our attempts to use interpolation and other techniques to estimate data for missing values, certain loan records contained major errors or were missing key data. These include missing loan amount, missing or incorrect state code, and loan termination recorded as prior to loan amortization. These series constituted a very small percentage of the records and could not have been properly re-estimated.

IV. DATA USED FOR THE CLAIM AND PREPAYMENT ANALYSIS

A. Data in the Regression Analysis

Regression analysis was used to estimate equations to predict the probability of borrowers prepaying or claiming on their mortgages. This section presents the historical data subsets used for the regression analysis and the other analyses used to model the behavior of additional loan categories.

Only loans with consistent properties were used in the regression analysis. Such loans are defined as:

- o Mortgages without graduated payments
- o Mortgages with amounts less than or equal to the official FHA ceiling
- o Mortgages with LTV ratios between 75 and 97 percent, but not at exactly 85, 90, or 95 percent (in recent years)
- o Mortgages with terms of 20, 25, or 30 years

The data in these categories comprise over 75 percent of the mortgages originating between Fiscal Years 1975 and 1989.

B. Data Analyzed Independent of the Primary Regression Analysis

A number of loan categories were not analyzed in the main regression analysis because their properties were inconsistent with most of the other data. The following sections outline the reasons for separating these categories from the main regression analysis and the methodology used for including the data in the cash flow model.

1. Loans Above the FHA Ceiling

In each year, there were a number of mortgages above the official FHA ceiling, even accounting for the premium being financed along with the mortgage (since 1984). These loans are comprised of a wide variety of exceptions, such as loans in Alaska, Hawaii, special programs, and other special cases. All of the loans above the ceiling comprised less than 1 percent of all of the loans.

A variable in the A-43 database indicates if the mortgage was insured under a special program. The special programs include solar homes, housing for veterans, housing for the elderly, and other similar programs. The mortgages in these cases may exceed the FHA ceiling. In a sample of 1985 mortgages, the special programs accounted for approximately 10 percent of the business, excluding mortgages in Alaska and Hawaii.

Certain variables in the A-43 database that cannot be left blank. If a program code is omitted or inputted incorrectly, the default value is 00, which signifies no special program code. It is likely that the code was not always correctly entered in the database -- thereby understating the number of loans under the special programs.

To include these loans in the cash flow analysis, the claim rates and prepayment rates had to be estimated. Because many of these loans exceeded the FHA ceiling by a small amount, this subset of loans were treated as loans in the next highest loan size category, category 7.

2. Loans Outside the 75 to 97 Percent LTV Range

Most of the LTV ratios fell between 75 and 97 percent. The loans with LTV ratios below 75 percent are an unusual subset because the FHA does not generally need to guarantee a loan with such a large downpayment. The subset of loans with less than a 3 percent downpayment may also have unusual properties because that falls below the minimum downpayment requirement.

For the cash flow analysis, the categories consisting of loans with LTV ratios below 75 percent and above 97 percent had to be grouped with a category used in the regression equations. The criteria for the "grouping" was an analysis of the aggregated loan termination rates. Table C-5 presents the 5-year cumulative claim and prepayment rates for the LTV ratio categories:

Table C-5: Cumulative Loan Termination Rates by LTV Ratio Category

	Loan-to-Value Ratio	5-Year Cumulative Claim Rate	5-Year Cumulative Prepayment Rate
***	30 - 75%	1.65%	43.16%
	75 - 85%	3.78%	35.85%
	85 - 90%	4.44%	29.12%
	90 - 93%	4.92%	24.42%
	93 - 95%	6.39%	21.59%
	95 - 97%	7.87%	19.13%
***	97 - 100%	8.82%	18.29%
	Investor	8.33%	28.72%

*** Not in the regression analysis

The loans with 30 to 75 percent LTV ratios were grouped with the loans with LTV ratios between 75 and 85 percent because the claim and prepayment rates were the closest ones. The loans with LTV ratios of 97 to 100 percent were grouped with the loans with LTV ratios between 95 and 97 percent. Although the 8.82 percent 5-year cumulative claim rate on these 97 to 100 percent loans is closer to the 8.33 percent on "Investor" loans, the prepayment rates differ significantly. The 5-year cumulative prepayment rate of 19.13 percent (95 to 97 percent LTV) is much closer to 18.29 (97 to 100 percent LTV) than 28.72 (Investor loans).

Although there are differences between the claim rates of the categories of loans not in the regression analysis and the categories that they were grouped with, there is no significant net difference. The claim rate is understated for loans with 30 to 75 percent LTV ratios by approximately 2 percent (1.65 to 3.78 percent) whereas the claim rate is overstated for loans with 97 to 100 percent LTV ratios by approximately 1 percent (8.82 to 7.87 percent). In 1989, 5.4 percent of all loans had 30 to 75 percent LTV ratios and 7.2 percent had 97 to 100 percent LTV ratios (see Table C-1 for further details). It should be noted, though, that ARMs are more risky than FRMs and that including ARMs with FRMs could understate future default losses.

3. LTV Ratios of 85, 90, and 95 percent for Selected Years

In the late 1980's, the number of mortgages amortized increased significantly. To account for the increased business and workload, certain "short-cuts" were apparently used. The best known of these is "streamlined refinancing" -- a mortgage that is refinanced without a reappraisal, which was possible as long as the borrower did not increase the remaining size of the loan. With no reappraisal, the LTV ratio is unknown. Often it was apparently entered as exactly 85, 90, or 95 percent; normally one would expect that the original LTV ratio or the ratio of the current loan to the original house price would be recorded. If an LTV ratio of exactly 85, 90, or 95 percent was entered into the database in the late 1980's, the loan record was removed from the regression analysis.

MMI FUND ANALYSIS

Table C-6 reports the percentage of loans with these LTV ratios in each year. If the percentage with the specific LTV ratios rose suddenly, those loans were separated from the regression analysis. The increase in the number of 95 percent LTV loans was not as substantial as for the 85 percent and 90 percent LTV ratio loans. At its peak in 1988, only 2.9 percent of the loans had an LTV ratio of 95 percent. In 1985, 4.3 percent of the loans had an LTV ratio of 85 percent. In 1987, 6.3 percent of the loans had an LTV ratio of 90 percent.

Table C-6: Percentage of Loans with Certain Exact LTV Ratio

LTV Ratio				LTV Ratio			
<u>Year of Loan</u>	<u>85%</u>	<u>90%</u>	<u>95%</u>	<u>Year of Loan</u>	<u>85%</u>	<u>90%</u>	<u>95%</u>
<u>Amortization</u>				<u>Amortization</u>			
1975	0.2	0.9	1.8	1983	0.4	0.7	1.2
1976	0.1	0.5	1.6	1984	0.9	1.0	1.9
1977	0.1	0.5	1.5	1985	<u>4.3</u>	1.0	1.8
1978	0.1	0.4	1.3	1986	<u>1.3</u>	<u>2.1</u>	2.0
1979	0.1	0.4	1.1	1987	<u>2.6</u>	<u>6.3</u>	2.4
1980	0.2	0.6	1.1	1988	<u>1.7</u>	<u>2.3</u>	2.9
1981	0.5	0.5	0.9	1989	<u>1.0</u>	<u>2.2</u>	<u>2.6</u>
1982	0.2	0.5	1.9				

(The underlined loans have been separated from the regression analysis)

These apparent errors comprised a significant portion of the business, but were not an excessive part of the refinancings. It has been estimated that as much as 40 percent of the business in 1987 was due to refinancings. Even if all of the "streamlined" refinancings were entered into the A-43 database as 85, 90, or 95 percent, that would still only be 11.3 percent of the 1987 mortgages. In short, it appears that the "streamlined" refinancings did not have a major effect in skewing the data.

Because the proportion of loans with 85, 90, and 95 percent LTV ratios jumped after 1984, it is unlikely that these LTV ratios were accurate. In the analysis, the claim rates (and prepayment rates) were compared to those of the other LTV ratio categories. The following list describes which LTV ratio categories these apparently inaccurate 85, 90, and 95 percent LTV ratios fit into:

- o 85 Percent LTV Mortgages (1985 - 1988): Performed as Investor Loans
The high claim rates and low prepayment rates best matched with loans in the Investor category. This also remains consistent with our assumption that these loans were "streamlined" refinancings of Investor loans.
- o 90 Percent LTV Mortgages (1986 - 1989): Performed as 95 to 97 Percent LTV Mortgages
The best fit was with the loans in the 95 to 97 percent LTV ratio category. This suggests that the entry of an LTV ratio of exactly 90 percent into the A-43 database overstated the true downpayment.

o 95 Percent LTV Mortgages (1988 - 1989): Performed as 95 to 97 Percent LTV Mortgages

These loans appear to have been in the proper LTV ratio category originally. The increased number of mortgages with a 95 percent LTV ratio may have been solely the result of more loans with a 5 percent downpayment.

4. 15-Year Mortgages

Before 1983, 15-year mortgages accounted for an average of less than 0.5 percent of the business. From 1983 to 1987, however, 15-year mortgages accounted for over 7 percent of the business each year (see Table C-3). Our analysis of the historical performance of 15-year loans revealed that the claim rates were usually lower than on 30-year mortgages.

To maintain these mortgages in the database for the cash flow analysis, a comparison of the historical performance of these loans to the 30-year loans was performed at an aggregate level. The analysis revealed that, on average, the probability of a claim on a 15-year mortgage that originated between 1983 and 1987 was two thirds of the probability of a claim on a 30-year mortgage. The faster amortization of 15-year mortgages would account for a lower claim rate, as would a lower initial LTV ratio.

5. Graduated Payment Mortgages (GPMs)

The GPMs were specifically isolated because the mortgage amortization schedule differs significantly from the Fixed and Adjustable Rate Mortgages. Unlike a Fixed or Adjustable Rate Mortgage, the loan balance on a GPM increases over the first 5 or 10 years, depending on the specific GPM type. This difference necessitated the separation of these mortgages.

Holding the LTV ratio constant, GPMs should default more often. However, the 245a GPMs FHA began insuring in 1975 have a much higher minimum LTV ratio (almost 10 percent) thereby offsetting the impact of negative amortization on default. The 245b GPMs FHA began insuring in 1980 have the same LTV minimum as other mortgages and these have much higher default rates; consequently, the FHA cancelled that program in 1987. Because the predominant GPM business still on FHA's books and all that is being added is from the 245a program, the forecasted default experience of GPMs is assumed to be the same of that of FRMs.

V. HISTORICAL SUMMARY TABLES

The following pages contain much of the data used for the historical data analysis. The first table shows the dollar amount of mortgages amortized in each fiscal year from 1975 to 1989. The next set of tables contain data demonstrating the percentage distribution of the dollar amount of mortgages by loan size category and LTV ratio category, for each fiscal amortization year.

The next set of tables contain data for the number of mortgages, the conditional claim rates, and the conditional prepayment rates for the following subsets of data:

- (8 categories) o 30-year Fixed and Adjustable Rate Mortgages, each Loan-to-Value (LTV) ratio category
- (8 categories) o 30-year Fixed and Adjustable Rate Mortgages, each Loan Size category
- (1 category) o 15-year mortgages, Fixed and Adjustable Rate Mortgages
- (1 category) o Graduated Payment Mortgages
- (3 categories) o 30-year Fixed and Adjustable Mortgages, each special LTV ratio category removed from the regression analysis (85, 90, and 95 percent for selected loan amortization years)

DISTRIBUTION OF MORTGAGE DOLLARS

Fiscal Amortization Year	Mortgages Originating (Billion \$)
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1975	4.6
1976	5.7
1977	7.1
1978	9.9
1979	15.4
1980	14.7
1981	10.2
1982	7.3
1983	26.3
1984	15.6
1985	23.5
1986	56.5
1987	68.5
1988	35.3
1989	37.0

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1975

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.33	0.29	0.39	0.37	0.39	0.74	0.44	0.02	2.97
2. 75 - 85%	0.24	0.26	0.42	0.54	0.68	1.89	1.18	0.01	5.21
3. 85 - 90%	0.39	0.48	0.86	1.22	1.74	4.62	2.83	0.05	12.18
4. 90 - 93%	0.44	0.60	0.95	1.51	2.24	4.81	4.57	0.04	15.16
5. 93 - 95%	0.99	1.03	1.73	2.35	2.85	6.62	2.11	0.04	17.72
6. 95 - 97%	3.07	3.73	3.79	5.72	5.91	6.20	0.70	0.01	29.14
7. >= 97%	1.45	1.63	1.72	2.08	1.31	1.41	0.07	0.00	9.66
8. Investor	0.49	0.57	0.79	1.02	1.06	2.22	1.62	0.19	7.96
TOTAL	7.40	8.60	10.64	14.81	16.16	28.50	13.53	0.36	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1976

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.38	0.28	0.29	0.34	0.33	0.43	0.21	0.01	2.27
2. 75 - 85%	0.24	0.26	0.34	0.51	0.77	1.31	0.61	0.02	4.06
3. 85 - 90%	0.49	0.55	0.79	1.09	1.39	2.84	1.94	0.04	9.13
4. 90 - 93%	0.56	0.61	0.90	1.41	1.89	6.24	3.88	0.04	15.53
5. 93 - 95%	1.27	1.26	1.82	2.90	2.94	8.41	0.89	0.03	19.53
6. 95 - 97%	4.05	3.79	5.48	8.01	5.95	4.37	0.40	0.02	32.07
7. >= 97%	1.88	1.75	2.21	1.88	1.34	0.95	0.08	0.01	10.10
8. Investor	0.56	0.62	0.84	1.09	0.96	1.74	1.07	0.44	7.33
TOTAL	9.42	9.12	12.67	17.22	15.58	26.29	9.09	0.61	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1977

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.38	0.27	0.39	0.44	0.37	0.58	0.19	0.02	2.65
2. 75 - 85%	0.27	0.26	0.41	0.72	0.87	1.44	0.69	0.05	4.70
3. 85 - 90%	0.50	0.51	0.93	1.37	1.65	3.34	2.03	0.09	10.42
4. 90 - 93%	0.65	0.68	1.19	1.99	2.83	9.11	2.14	0.05	18.65
5. 93 - 95%	1.32	1.32	2.42	3.20	5.54	5.82	0.60	0.03	20.26
6. 95 - 97%	3.82	3.73	6.65	7.44	4.99	2.19	0.20	0.03	29.05
7. >= 97%	1.36	1.40	2.09	1.51	1.18	0.37	0.09	0.01	8.02
8. Investor	0.47	0.54	0.87	1.00	0.91	1.48	0.55	0.43	6.25
TOTAL	8.77	8.71	14.94	17.67	18.35	24.34	6.49	0.72	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1978

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.35	0.31	0.37	0.36	0.44	0.61	0.54	0.01	3.00
2. 75 - 85%	0.22	0.26	0.47	0.57	0.79	1.17	1.09	0.02	4.58
3. 85 - 90%	0.39	0.48	0.81	1.22	1.40	2.78	1.85	0.03	8.96
4. 90 - 93%	0.54	0.72	1.25	2.20	2.98	4.86	4.48	0.04	17.09
5. 93 - 95%	1.05	1.42	2.01	3.56	3.13	3.65	3.44	0.04	18.30
6. 95 - 97%	2.79	3.68	5.18	5.53	4.43	6.38	5.80	0.08	33.86
7. >= 97%	1.02	1.21	1.16	1.06	0.84	1.20	0.96	0.01	7.48
8. Investor	0.45	0.58	0.78	0.90	0.93	1.61	1.24	0.24	6.72
TOTAL	6.82	8.66	12.03	15.40	14.95	22.27	19.39	0.48	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1979

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.44	0.43	0.52	0.65	0.60	1.08	0.90	0.03	4.64
2. 75 - 85%	0.24	0.34	0.47	0.85	0.87	1.98	2.16	0.03	6.95
3. 85 - 90%	0.40	0.56	0.99	1.41	1.73	3.47	3.76	0.03	12.35
4. 90 - 93%	0.57	0.85	1.74	2.79	3.75	8.19	6.25	0.07	24.21
5. 93 - 95%	0.98	1.15	1.70	2.17	2.13	3.52	2.31	0.02	13.97
6. 95 - 97%	2.22	2.87	3.92	4.48	4.15	6.43	3.26	0.05	27.38
7. >= 97%	0.69	0.47	0.50	0.55	0.49	0.74	0.34	0.01	3.78
8. Investor	0.53	0.60	0.79	0.90	0.96	1.63	1.23	0.08	6.72
TOTAL	6.07	7.27	10.63	13.79	14.68	27.05	20.19	0.32	100.00

**DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES**

Loan Amortization Year 1980

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.71	0.67	0.77	1.03	1.26	2.47	0.85	0.10	7.86
2. 75 - 85%	0.36	0.46	0.83	1.18	1.61	4.47	1.52	0.08	10.50
3. 85 - 90%	0.57	0.82	1.49	2.43	3.05	8.27	2.93	0.10	19.67
4. 90 - 93%	0.61	0.86	1.55	2.38	2.99	7.28	1.49	0.08	17.24
5. 93 - 95%	1.00	1.10	1.59	1.83	1.89	4.02	1.09	0.03	12.55
6. 95 - 97%	1.86	2.22	3.14	3.43	3.17	5.90	1.49	0.09	21.31
7. >= 97%	0.45	0.29	0.31	0.33	0.31	0.53	0.07	0.02	2.30
8. Investor	0.60	0.64	0.85	1.11	1.47	2.39	0.92	0.38	8.56
TOTAL	6.16	7.06	10.54	13.73	15.75	35.52	10.36	0.87	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1981

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.03	0.71	0.98	1.06	1.23	1.79	1.47	0.03	8.31
2. 75 - 85%	0.52	0.64	1.27	1.66	2.06	3.53	2.89	0.03	12.60
3. 85 - 90%	0.80	1.00	1.89	2.53	3.41	7.08	4.03	0.02	20.76
4. 90 - 93%	0.64	0.69	1.12	1.43	1.64	3.36	1.88	0.00	10.77
5. 93 - 95%	1.19	1.12	1.52	1.82	1.81	3.73	1.70	0.01	12.89
6. 95 - 97%	2.08	1.95	2.59	2.87	2.55	5.23	2.32	0.02	19.62
7. >= 97%	0.43	0.17	0.19	0.20	0.19	0.25	0.06	0.00	1.50
8. Investor	1.41	1.09	1.32	1.80	2.03	2.97	2.12	0.82	13.56
TOTAL	8.11	7.37	10.89	13.36	14.93	27.95	16.46	0.93	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1982

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.91	1.23	1.81	1.60	1.44	2.89	1.55	0.17	12.61
2. 75 - 85%	0.83	0.96	1.62	1.85	2.35	4.12	2.22	0.13	14.07
3. 85 - 90%	0.83	0.95	1.62	2.03	2.40	5.44	2.68	0.04	16.00
4. 90 - 93%	0.79	0.68	1.08	1.32	1.51	3.51	1.70	0.01	10.61
5. 93 - 95%	1.16	0.97	1.34	1.61	1.99	4.42	2.14	0.01	13.65
6. 95 - 97%	1.98	1.62	2.59	2.16	2.34	4.78	2.19	0.03	17.69
7. >= 97%	0.34	0.10	0.11	0.11	0.14	0.13	0.03	0.00	0.95
8. Investor	1.61	1.31	1.64	1.94	2.15	3.03	1.64	1.10	14.42
TOTAL	9.46	7.82	11.82	12.61	14.32	28.32	14.16	1.50	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1983

LTV Category		Loan Size Category							
Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.50	1.25	1.92	1.73	1.73	3.36	2.23	0.28	13.99
2. 75 - 85%	0.66	0.87	1.50	1.82	2.09	4.08	2.45	0.24	13.70
3. 85 - 90%	0.53	0.80	1.39	1.91	2.27	4.93	3.31	0.16	15.29
4. 90 - 93%	0.53	0.68	1.07	1.48	1.73	3.76	2.38	0.07	11.70
5. 93 - 95%	0.85	1.00	1.33	1.76	2.11	4.18	2.45	0.06	13.74
6. 95 - 97%	1.15	1.33	1.79	2.17	2.64	5.22	3.11	0.07	17.48
7. >= 97%	0.18	0.12	0.14	0.20	0.24	0.37	0.15	0.01	1.41
8. Investor	1.03	0.95	1.37	1.64	1.78	2.97	1.72	1.25	12.70
TOTAL	6.43	6.99	10.50	12.70	14.60	28.85	17.79	2.13	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1984

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.46	1.10	1.05	1.29	1.17	1.76	1.07	0.19	9.11
2. 75 - 85%	0.48	0.53	0.64	0.86	0.90	1.45	0.83	0.18	5.88
3. 85 - 90%	0.71	0.80	1.19	1.67	2.01	3.91	2.65	0.29	13.23
4. 90 - 93%	0.66	0.70	1.02	1.42	1.71	3.46	2.55	0.14	11.65
5. 93 - 95%	0.93	0.88	1.25	1.73	1.98	3.89	2.67	0.10	13.43
6. 95 - 97%	1.55	1.66	2.31	2.85	3.32	6.82	3.98	0.14	22.62
7. >= 97%	0.84	0.61	0.80	0.90	0.96	1.79	0.77	0.07	6.74
8. Investor	1.69	1.48	1.96	2.25	2.40	3.70	2.10	1.77	17.35
TOTAL	8.31	7.75	10.21	12.98	14.47	26.79	16.61	2.87	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1985

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.31	0.92	1.14	1.20	1.12	1.79	1.73	0.19	9.40
2. 75 - 85%	0.62	0.60	0.90	1.11	1.20	2.21	1.92	0.24	8.81
3. 85 - 90%	0.86	0.93	1.40	1.92	2.22	4.51	3.71	0.73	16.28
4. 90 - 93%	0.56	0.60	0.89	1.26	1.63	3.40	3.11	0.13	11.59
5. 93 - 95%	0.84	0.80	1.12	1.53	1.92	4.15	3.61	0.10	14.07
6. 95 - 97%	1.32	1.41	1.99	2.52	3.12	6.87	5.13	0.14	22.50
7. >= 97%	0.31	0.20	0.30	0.33	0.35	0.65	0.35	0.06	2.55
8. Investor	1.21	1.05	1.40	1.80	1.99	3.27	2.24	1.84	14.80
TOTAL	7.02	6.52	9.13	11.67	13.56	26.86	21.82	3.42	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1986

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.17	1.03	1.39	1.38	1.41	2.29	1.75	0.26	10.68
2. 75 - 85%	0.60	0.71	1.15	1.41	1.62	2.77	1.98	0.31	10.55
3. 85 - 90%	0.60	0.80	1.36	1.89	2.37	4.71	3.16	0.45	15.34
4. 90 - 93%	0.52	0.67	1.12	1.56	2.05	3.96	3.03	0.19	13.09
5. 93 - 95%	0.63	0.78	1.16	1.61	1.98	3.94	2.99	0.14	13.23
6. 95 - 97%	0.98	1.30	2.12	2.72	3.38	6.62	4.04	0.18	21.34
7. >= 97%	0.39	0.46	0.53	0.32	0.35	0.59	0.27	0.02	2.93
8. Investor	0.74	0.82	1.25	1.60	1.86	3.25	1.98	1.33	12.85
TOTAL	5.64	6.57	10.08	12.50	15.02	28.12	19.20	2.87	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1987

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	1.18	1.14	1.37	1.40	1.37	2.11	1.47	0.15	10.18
2. 75 - 85%	0.71	0.86	1.29	1.51	1.70	2.82	1.87	0.17	10.93
3. 85 - 90%	0.54	0.76	1.28	1.71	2.11	4.14	2.62	0.29	13.45
4. 90 - 93%	0.83	1.03	1.64	2.21	2.73	4.72	3.16	0.19	16.50
5. 93 - 95%	0.57	0.78	1.23	1.57	1.96	3.64	2.53	0.10	12.37
6. 95 - 97%	1.03	1.50	2.36	3.03	3.72	6.73	3.60	0.12	22.09
7. >= 97%	0.48	0.64	0.61	0.43	0.44	0.62	0.27	0.01	3.49
8. Investor	0.65	0.79	1.15	1.50	1.63	2.89	1.53	0.83	10.98
TOTAL	5.99	7.49	10.93	13.35	15.65	27.66	17.05	1.87	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1988

LTV Category

Loan Size Category

Percent	1	2	3	4	5	6	7	8	TOTAL
1. < 75%	0.97	0.62	0.69	0.68	0.51	0.76	0.64	0.05	4.91
2. 75 - 85%	0.67	0.55	0.74	0.77	0.70	1.13	1.00	0.05	5.61
3. 85 - 90%	0.75	0.82	1.21	1.48	1.66	3.11	2.53	0.11	11.66
4. 90 - 93%	1.18	1.23	1.90	2.33	2.64	4.43	3.45	0.09	17.25
5. 93 - 95%	1.05	1.26	1.90	2.15	2.42	4.47	3.49	0.09	16.82
6. 95 - 97%	2.16	2.62	3.75	4.22	4.35	8.46	5.42	0.10	31.09
7. >= 97%	1.05	1.09	0.98	0.74	0.58	0.84	0.32	0.00	5.60
8. Investor	0.66	0.60	0.79	0.91	0.91	1.56	1.29	0.33	7.05
TOTAL	8.50	8.80	11.95	13.28	13.77	24.76	18.14	0.81	100.00

DISTRIBUTION OF MORTGAGE DOLLARS
BY LOAN SIZE AND LTV RATIO CATEGORIES

Loan Amortization Year 1989

LTV Category		Loan Size Category								TOTAL
Percent		1	2	3	4	5	6	7	8	
1. < 75%		0.91	0.60	0.58	0.54	0.48	0.69	0.57	0.05	4.42
2. 75 - 85%		0.56	0.49	0.56	0.60	0.63	0.90	0.97	0.05	4.76
3. 85 - 90%		0.72	0.78	1.10	1.27	1.59	2.79	2.97	0.07	11.30
4. 90 - 93%		1.18	1.21	1.97	2.20	2.66	4.37	3.92	0.10	17.61
5. 93 - 95%		1.10	1.27	1.94	2.07	2.52	4.52	4.14	0.07	17.62
6. 95 - 97%		2.38	2.85	3.90	4.05	4.59	8.20	6.49	0.12	32.59
7. >= 97%		1.05	1.09	0.92	0.77	0.70	0.94	0.44	0.02	5.93
8. Investor		0.49	0.49	0.62	0.66	0.78	1.25	1.16	0.31	5.76
TOTAL		8.40	8.79	11.60	12.15	13.96	23.66	20.65	0.80	100.00

NUMBER OF MORTGAGES

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS LESS THAN 75%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	5,717	5,416	7,111	8,316	13,023	19,588	14,415	16,720	58,532	21,642	30,843	78,938	96,391	29,115	27,590
2	5,674	5,335	7,012	8,189	12,882	19,469	14,321	16,593	58,118	21,519	30,543	78,055	95,727	28,783	
3	5,410	4,936	6,604	7,764	12,563	19,108	14,087	11,823	56,788	20,757	24,530	72,840	93,316		
4	4,922	4,440	6,084	7,483	12,328	18,880	12,125	9,906	54,181	14,705	16,225	69,278			
5	4,418	4,067	5,832	7,325	12,244	18,058	11,017	8,006	39,975	9,478	13,821				
6	4,034	3,891	5,699	7,249	11,849	17,335	9,880	5,003	25,842	8,019					
7	3,849	3,779	5,630	7,009	11,511	16,479	7,302	3,599	22,164						
8	3,767	3,721	5,453	6,828	11,122	14,265	5,268	3,093							
9	3,711	3,611	5,280	6,581	10,341	11,568	4,589								
10	3,585	3,483	5,089	6,125	9,243	10,469									
11	3,442	3,345	4,780	5,585	8,612										
12	3,318	3,131	4,376	5,255											
13	3,123	2,887	4,097												
14	2,864	2,706													
15	2,705														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS OF 75 - 85%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	8,734	8,150	10,783	10,597	13,454	18,500	15,365	13,742	53,564	13,432	28,852	82,547	108,048	31,897	27,589
2	8,689	8,085	10,689	10,493	13,395	18,396	15,327	13,670	53,382	13,389	28,714	81,917	107,518	31,675	
3	8,379	7,630	10,149	10,034	13,234	18,151	15,116	10,312	52,656	13,062	23,835	77,379	105,534		
4	7,662	6,909	9,449	9,740	13,071	17,966	13,178	8,728	50,760	9,399	16,316	73,847			
5	6,855	6,331	9,097	9,589	12,979	17,399	11,979	7,046	38,848	6,001	13,703				
6	6,326	6,025	8,938	9,491	12,658	16,851	10,722	4,402	25,484	4,970					
7	6,054	5,885	8,869	9,235	12,373	16,152	7,807	3,019	21,533						
8	5,938	5,824	8,597	8,999	12,041	14,114	5,663	2,556							
9	5,882	5,638	8,352	8,709	11,245	11,423	4,881								
10	5,688	5,461	8,075	8,131	10,157	10,258									
11	5,479	5,254	7,571	7,399	9,468										
12	5,245	4,932	6,918	6,918											
13	4,922	4,517	6,489												
14	4,480	4,239													
15	4,224														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS OF 85 - 90%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	19,814	17,878	23,193	20,620	22,353	25,605	17,378	13,125	50,031	24,547	36,105	94,464	104,638	53,034	61,211
2	19,760	17,800	23,104	20,535	22,293	25,566	17,357	13,109	49,929	24,508	36,014	93,979	104,439	52,884	
3	19,238	17,053	22,328	19,930	22,072	25,335	17,161	10,551	49,389	23,981	30,835	90,070	103,228		
4	17,822	15,581	20,933	19,461	21,820	25,055	15,482	9,281	47,802	17,703	21,606	86,495			
5	15,930	14,241	20,221	19,191	21,649	24,335	14,416	7,652	37,036	11,749	18,007				
6	14,476	13,603	19,890	19,033	21,222	23,542	13,113	4,665	25,084	9,654					
7	13,859	13,320	19,735	18,584	20,751	22,648	9,915	3,111	21,050						
8	13,558	13,194	19,179	18,144	20,207	19,943	7,475	2,629							
9	13,443	12,777	18,625	17,672	19,018	16,423	6,465								
10	13,049	12,413	18,041	16,578	17,294	14,843									
11	12,611	11,968	16,921	15,147	16,036										
12	12,157	11,129	15,427	14,116											
13	11,354	10,176	14,427												
14	10,420	9,524													
15	9,764														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS OF 90 - 93%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	24,256	28,464	40,075	32,041	27,228	24,514	16,880	12,236	45,842	24,620	37,428	87,545	102,628	64,543	69,253
2	24,209	28,394	39,956	31,908	27,171	24,478	16,862	12,218	45,784	24,577	37,366	87,219	102,506	64,409	
3	23,686	27,235	38,614	31,058	26,920	24,227	16,644	10,313	45,204	24,056	33,062	84,200	101,550		
4	21,859	24,904	36,173	30,334	26,562	23,881	15,091	9,083	43,676	18,573	24,141	80,951			
5	19,601	22,533	34,910	29,876	26,263	23,140	14,100	7,630	35,073	12,689	20,324				
6	17,802	21,487	34,304	29,582	25,759	22,406	12,908	4,789	24,576	10,360					
7	16,962	20,986	34,030	28,928	25,152	21,508	9,873	3,253	20,735						
8	16,597	20,792	33,070	28,288	24,486	19,130	7,338	2,689							
9	16,447	20,086	32,098	27,564	23,003	15,871	6,340								
10	15,885	19,349	31,072	25,873	20,851	14,325									
11	15,347	18,610	29,002	23,555	19,436										
12	14,752	17,303	26,501	22,006											
13	13,786	15,664	24,730												
14	12,602	14,613													
15	11,781														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS OF 93 - 95%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	31,282	40,259	49,441	46,331	45,673	38,020	25,652	16,451	59,800	31,984	48,741	111,446	127,126	92,541	98,831
2	31,224	40,187	49,282	46,168	45,568	37,977	25,607	16,403	59,718	31,937	48,669	111,106	126,980	92,384	
3	30,534	38,630	47,496	44,929	45,120	37,579	25,189	14,095	59,090	31,261	43,698	107,490	125,829		
4	28,093	34,910	44,189	43,846	44,515	36,954	23,046	12,571	57,000	24,922	32,786	103,092			
5	24,777	31,306	42,435	43,097	44,039	35,786	21,431	10,609	47,080	17,418	27,418				
6	22,239	29,692	41,563	42,649	43,149	34,628	19,612	6,730	34,232	14,263					
7	21,183	28,894	41,194	41,624	42,151	33,297	15,427	4,572	28,851						
8	20,630	28,567	39,996	40,573	41,023	29,873	11,829	3,700							
9	20,347	27,530	38,789	39,456	38,666	25,466	10,209								
10	19,631	26,553	37,430	37,219	35,462	23,102									
11	18,902	25,492	35,081	34,117	33,153										
12	18,163	23,769	32,181	31,984											
13	17,056	21,696	30,169												
14	15,632	20,358													
15	14,655														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS OF 95 - 97%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	59,739	77,531	82,389	98,764	105,673	71,014	42,652	24,400	78,277	56,158	80,432	183,598	233,279	159,489	173,955
2	59,615	77,239	82,090	98,524	105,446	70,852	42,524	24,312	78,144	56,060	80,287	183,098	232,957	159,150	
3	58,053	73,994	78,924	95,884	104,076	69,631	41,376	20,703	77,010	54,642	72,703	177,079	230,251		
4	53,259	66,637	73,123	93,122	102,222	67,970	37,063	18,030	73,646	44,051	55,179	169,000			
5	47,213	59,660	69,775	91,209	100,826	65,364	34,129	15,037	60,996	30,994	45,489				
6	42,285	56,175	67,974	90,032	98,431	62,888	30,955	10,547	44,703	24,825					
7	39,962	54,447	67,131	87,753	95,997	60,226	24,508	7,099	37,253						
8	38,745	53,688	65,033	85,538	93,280	54,538	18,871	5,710							
9	38,142	51,677	63,073	83,116	88,349	46,880	16,223								
10	36,643	49,733	60,873	78,474	81,185	42,588									
11	35,313	47,856	57,362	72,466	75,819										
12	33,943	45,074	53,142	68,042											
13	31,883	41,640	50,057												
14	29,496	39,199													
15	27,810														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV RATIOS GREATER THAN OR EQUAL TO 97%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	21,408	26,582	24,137	24,222	16,394	8,632	4,027	1,815	7,157	18,738	10,070	30,086	44,299	38,944	41,627
2	21,354	26,438	24,037	24,169	16,319	8,611	4,004	1,787	7,140	18,703	10,048	30,002	44,200	38,764	
3	20,588	24,996	22,985	23,362	15,902	8,333	3,765	1,473	7,009	18,221	9,091	28,964	43,373		
4	18,716	22,369	21,226	22,669	15,421	8,003	3,328	1,221	6,627	15,120	7,021	27,392			
5	16,419	19,993	20,233	22,106	15,118	7,636	3,046	998	5,573	11,258	5,863				
6	14,662	18,807	19,680	21,727	14,631	7,311	2,782	733	4,251	9,310					
7	13,837	18,205	19,394	21,128	14,233	6,974	2,385	571	3,630						
8	13,392	17,886	18,718	20,590	13,809	6,363	1,973	479							
9	13,159	17,194	18,175	20,020	13,057	5,645	1,738								
10	12,629	16,580	17,571	19,008	12,148	5,203									
11	12,146	15,971	16,605	17,580	11,405										
12	11,716	15,031	15,503	16,559											
13	11,065	13,979	14,657												
14	10,242	13,174													
15	9,675														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LTV CATEGORY: INVESTOR)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	13,833	15,064	15,136	18,387	22,922	23,847	26,527	19,865	57,161	42,682	51,701	101,772	106,722	38,456	31,652
2	13,782	15,006	15,067	18,292	22,806	23,502	26,470	19,683	56,926	42,548	51,510	101,031	106,366	38,193	
3	13,490	14,469	14,591	17,783	22,476	22,506	25,862	15,334	55,871	41,205	45,160	95,748	104,710		
4	12,716	13,410	13,806	17,334	22,123	22,140	22,818	12,727	53,454	32,750	32,457	90,586			
5	11,712	12,445	13,390	16,987	21,874	21,352	20,543	10,383	44,760	22,513	26,429				
6	10,873	11,942	13,096	16,754	21,309	20,488	18,410	7,389	32,215	18,296					
7	10,469	11,646	12,907	16,342	20,701	19,524	14,538	5,285	27,251						
8	10,199	11,454	12,568	15,879	19,943	17,452	10,752	4,366							
9	10,038	11,086	12,138	15,358	18,876	14,678	9,063								
10	9,685	10,645	11,699	14,575	17,358	13,157									
11	9,339	10,259	11,054	13,446	16,182										
12	8,971	9,621	10,197	12,582											
13	8,493	8,892	9,593												
14	7,901	8,308													
15	7,459														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 1)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	25,542	36,944	39,358	38,243	44,559	38,445	33,069	26,249	56,484	40,880	45,468	79,188	96,195	75,753	80,966
2	25,451	36,699	39,123	38,023	44,290	38,318	32,907	26,040	56,224	40,736	45,286	78,842	95,868	75,440	
3	24,537	34,812	37,380	36,534	43,137	37,384	31,825	22,098	54,832	39,433	42,131	76,030	94,356		
4	22,709	31,779	34,699	35,062	41,826	36,212	28,764	19,268	51,966	34,386	35,727	72,281			
5	20,579	28,952	32,874	33,862	40,859	34,377	26,458	16,606	45,366	28,124	31,661				
6	18,760	27,232	31,679	33,033	39,290	32,735	24,331	12,741	37,636	24,616					
7	17,801	26,192	31,012	31,832	37,897	31,106	20,814	9,972	33,496						
8	17,156	25,565	29,835	30,710	36,414	28,882	17,548	8,496							
9	16,732	24,512	28,770	29,630	34,590	26,185	15,601								
10	15,998	23,493	27,607	28,214	32,438	24,302									
11	15,336	22,569	26,342	26,597	30,574										
12	14,650	21,418	24,860	25,206											
13	13,886	20,202	23,605												
14	13,103	19,149													
15	12,432														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 2)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	22,343	27,038	29,141	34,809	36,196	29,198	19,607	14,163	44,248	26,984	31,350	73,556	96,970	63,712	66,230
2	22,250	26,889	29,001	34,643	36,062	29,101	19,555	14,075	44,102	26,910	31,262	73,254	96,708	63,490	
3	21,498	25,491	27,805	33,393	35,466	28,569	19,080	11,255	43,269	26,150	28,296	70,647	95,279		
4	19,668	22,852	25,766	32,329	34,663	27,958	17,176	9,649	41,248	21,682	22,370	67,446			
5	17,433	20,511	24,626	31,594	34,178	26,882	15,817	8,085	34,370	16,306	19,283				
6	15,654	19,265	23,964	31,180	33,195	25,855	14,447	5,653	26,329	13,786					
7	14,810	18,627	23,636	30,229	32,214	24,679	11,692	4,118	22,722						
8	14,317	18,321	22,832	29,373	31,191	22,541	9,262	3,438							
9	14,058	17,636	22,083	28,382	29,505	19,822	8,118								
10	13,478	16,923	21,290	26,915	27,378	18,129									
11	12,949	16,241	20,115	25,069	25,697										
12	12,402	15,355	18,721	23,714											
13	11,727	14,275	17,701												
14	10,951	13,462													
15	10,404														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 3)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	23,374	31,591	42,505	40,302	41,113	33,487	22,476	16,791	54,602	29,324	36,717	97,046	122,696	71,423	74,540
2	23,302	31,483	42,339	40,141	40,974	33,373	22,423	16,731	54,436	29,262	36,584	96,581	122,376	71,162	
3	22,609	30,240	40,753	38,883	40,417	32,777	22,045	13,348	53,587	28,456	32,553	92,842	120,740		
4	20,633	27,408	37,944	37,680	39,761	32,152	19,885	11,637	51,442	22,612	24,732	88,827			
5	18,190	24,467	36,336	36,961	39,301	31,007	18,390	9,717	41,472	16,047	20,916				
6	16,302	23,094	35,509	36,557	38,363	29,850	16,798	6,684	29,566	13,229					
7	15,440	22,430	35,143	35,598	37,429	28,648	13,383	4,200	25,246						
8	15,019	22,133	34,049	34,677	36,280	25,838	10,290	3,407							
9	14,810	21,332	33,026	33,588	34,281	22,349	8,919								
10	14,253	20,605	31,918	31,744	31,564	20,401									
11	13,746	19,815	30,075	29,348	29,476										
12	13,229	18,542	27,930	27,590											
13	12,475	17,148	26,291												
14	11,551	16,099													
15	10,878														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 4)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	28,329	37,335	43,732	43,344	41,221	33,057	22,101	14,001	55,163	31,175	41,520	105,454	130,639	69,752	66,834
2	28,261	37,212	43,582	43,200	41,100	32,930	22,058	13,942	55,009	31,102	41,376	104,919	130,300	69,514	
3	27,538	35,783	42,030	41,931	40,631	32,383	21,654	10,852	54,230	30,325	36,051	100,580	128,596		
4	25,198	32,299	39,215	40,835	40,094	31,893	19,402	9,255	52,111	23,256	26,152	96,290			
5	22,238	28,936	37,730	40,172	39,684	30,898	17,959	7,612	41,429	15,572	21,812				
6	19,997	27,415	36,994	39,835	38,848	29,846	16,310	4,830	28,775	12,547					
7	18,963	26,678	36,668	38,966	37,917	28,659	12,700	3,279	24,254						
8	18,444	26,395	35,675	38,060	36,841	25,695	9,481	2,665							
9	18,202	25,429	34,640	37,073	34,666	21,778	8,168								
10	17,930	24,557	33,490	34,922	31,692	19,761									
11	16,918	23,619	31,387	32,215	29,544										
12	16,298	22,158	28,808	30,287											
13	15,334	20,357	27,016												
14	14,110	19,073													
15	13,265														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 5)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	27,374	29,886	40,079	35,783	32,945	30,003	19,801	13,542	55,723	30,134	42,255	113,226	138,502	64,448	69,037
2	27,320	29,803	39,953	35,643	32,863	29,872	19,766	13,481	55,566	30,056	42,134	112,651	138,128	64,239	
3	26,691	28,647	38,589	34,654	32,536	29,413	19,422	10,469	54,876	29,322	36,170	107,692	136,299		
4	24,647	25,830	35,889	33,828	32,174	29,028	17,233	8,837	52,796	21,776	25,439	103,174			
5	21,948	23,253	34,515	33,324	31,928	28,169	15,948	7,121	41,042	13,954	20,875				
6	19,714	22,086	33,973	33,038	31,345	27,324	14,448	4,203	27,488	11,112					
7	18,738	21,542	33,744	32,291	30,710	26,205	10,762	2,710	22,788						
8	18,287	21,344	32,864	31,567	29,931	23,135	7,755	2,206							
9	18,097	20,636	31,967	30,751	28,193	18,960	6,537								
10	17,476	19,976	30,905	28,875	25,615	17,042									
11	16,857	19,225	28,939	26,385	23,947										
12	16,265	17,950	26,476	24,674											
13	15,242	16,363	24,772												
14	13,918	15,362													
15	12,991														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 6)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	41,373	43,337	45,971	42,038	45,307	50,635	30,289	22,813	93,263	47,543	72,429	184,368	213,721	99,946	100,799
2	41,305	43,240	45,798	41,890	45,233	50,421	30,225	22,737	93,027	47,448	72,225	183,309	213,207	99,643	
3	40,465	41,487	44,104	40,864	44,935	49,654	29,797	18,068	91,931	46,386	61,374	174,946	210,484		
4	37,441	37,561	41,054	40,051	44,516	49,096	26,398	15,641	88,790	33,745	41,346	167,589			
5	33,461	33,967	39,645	39,551	44,175	47,731	24,257	12,511	68,060	20,776	33,347				
6	30,341	32,409	39,014	39,206	43,470	46,328	21,779	6,943	43,598	16,119					
7	28,991	31,795	38,755	38,460	42,667	44,612	15,605	4,301	35,709						
8	28,407	31,540	37,693	37,671	41,721	38,867	10,542	3,515							
9	28,161	30,532	36,613	36,781	39,219	31,056	8,764								
10	27,290	29,464	35,405	34,431	35,300	27,610									
11	26,398	28,430	32,969	31,161	32,733										
12	25,421	26,400	29,778	28,990											
13	23,709	23,812	27,749												
14	21,626	22,201													
15	20,279														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 7)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	16,132	12,536	10,482	24,101	24,964	13,704	14,719	9,863	46,460	24,433	48,840	106,638	115,381	60,947	71,199
2	16,102	12,482	10,446	24,080	24,943	13,648	14,705	9,846	46,369	24,407	48,722	106,079	115,108	60,734	
3	15,737	11,823	10,062	23,832	24,836	13,516	14,555	7,858	45,931	23,919	41,687	101,012	113,269		
4	14,465	10,816	9,480	23,563	24,632	13,346	12,573	6,766	44,572	17,446	26,997	95,904			
5	12,836	9,906	9,243	23,290	24,474	12,900	11,248	5,344	34,216	9,998	21,016				
6	11,716	9,548	9,109	23,049	24,124	12,447	9,776	2,957	20,826	7,405					
7	11,225	9,339	9,041	22,623	23,686	11,885	6,466	1,773	16,605						
8	10,996	9,271	8,786	22,189	23,183	9,857	4,094	1,385							
9	10,913	8,976	8,556	21,690	21,767	7,139	3,253								
10	10,585	8,664	8,319	20,331	19,403	6,109									
11	10,198	8,328	7,754	18,004	17,856										
12	9,831	7,661	6,932	16,512											
13	9,145	6,823	6,387												
14	8,230	6,323													
15	7,683														

NUMBER OF 30-YEAR MORTGAGES IN FORCE (LOAN SIZE CATEGORY 8)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	316	677	997	658	415	1,191	834	930	4,421	3,330	5,593	10,920	9,027	2,038	2,103
2	316	676	995	658	415	1,188	833	923	4,408	3,320	5,562	10,772	8,998	2,020	
3	303	660	968	653	405	1,174	822	656	4,361	3,194	4,652	10,021	8,768		
4	268	615	936	641	396	1,164	700	494	4,201	2,320	2,968	9,130			
5	240	584	924	626	393	1,108	584	365	3,386	1,323	2,144				
6	213	573	902	619	373	1,064	493	267	2,169	883					
7	207	559	891	604	359	1,014	333	156	1,647						
8	200	557	880	592	350	863	197	110							
9	196	546	860	581	334	665	148								
10	185	535	836	551	308	591									
11	177	528	795	516	284										
12	169	506	742	489											
13	164	471	698												
14	148	452													
15	141														

NUMBER OF 15-YEAR MORTGAGES IN FORCE

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	630	704	533	374	429	509	515	740	33,704	17,433	30,303	79,932	74,143	17,049	15,979
2	626	702	530	373	428	509	514	736	33,631	17,380	30,221	79,493	73,823	16,963	
3	606	683	513	360	423	501	505	654	33,217	17,064	27,206	75,729	72,478		
4	568	640	486	331	413	485	459	591	32,264	14,748	21,114	72,195			
5	504	592	465	342	394	468	431	536	28,563	11,380	18,832				
6	468	564	448	334	377	447	396	426	22,273	10,013					
7	440	534	430	319	360	431	357	372	19,806						
8	424	511	404	309	354	389	320	337							
9	406	480	389	292	326	347	295								
10	384	454	375	277	292	320									
11	361	435	349	266	271										
12	335	407	327	254											
13	295	374	301												
14	262	339													
15	216														

NUMBER OF GRADUATED PAYMENT MORTGAGES (GPM) IN FORCE

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1			251	31,049	117,024	101,473	50,956	29,230	51,827	30,250	20,434	11,982	8,601	3,462	2,480
2			251	31,043	116,924	101,373	50,841	29,155	51,728	30,207	20,349	11,863	8,588	3,446	
3			250	30,836	116,433	100,801	50,373	22,378	51,280	29,543	17,599	10,959	8,458		
4			248	30,523	115,457	100,024	42,902	19,316	49,616	21,610	12,774	10,133			
5			246	30,154	114,240	97,566	38,664	15,225	38,588	14,050	10,053				
6			245	29,590	112,457	94,719	33,061	9,159	25,958	10,075					
7			243	29,013	110,480	90,713	21,168	5,690	19,990						
8			236	28,359	107,995	76,698	13,472	4,178							
9			234	27,672	101,867	59,267	10,710								
10			226	25,959	91,434	51,917									
11			208	23,346	84,036										
12			187	21,512											
13			171												
14															
15															

SPECIAL CASE: NUMBER OF 30-YEAR MORTGAGES IN FORCE (EXACTLY 85% LTV RATIO)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1											14,925	26,409	26,406	9,421	
2											14,853	26,207	26,296	9,269	
3											13,341	24,842	25,703		
4											9,614	23,186			
5											7,616				
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

SPECIAL CASE: NUMBER OF 30-YEAR MORTGAGES IN FORCE (EXACTLY 90% LTV RATIO)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1												17,378	66,099	30,863	30,867
2												17,333	65,924	30,751	
3												16,868	65,030		
4												16,208			
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

CONDITIONAL CLAIM PROBABILITY

SPECIAL CASE: NUMBER OF 30-YEAR MORTGAGES IN FORCE (EXACTLY 95% LTV RATIO)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1														16,875	15,383
2														16,740	
3															
4															
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

30-YEAR MORTGAGES (LTV RATIOS LESS THAN 75%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.00	0.00	0.00	0.01	0.00	0.00	0.03	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00
2	0.07	0.09	0.11	0.05	0.11	0.17	0.33	0.40	0.07	0.23	0.15	0.07	0.09	0.11	
3	0.22	0.20	0.12	0.08	0.16	0.36	0.75	1.01	0.34	0.54	0.84	0.40	0.24		
4	0.14	0.14	0.13	0.16	0.16	0.67	0.63	1.33	0.45	1.24	1.92	0.60			
5	0.14	0.17	0.07	0.12	0.34	0.33	0.87	1.42	0.67	1.98	1.59				
6	0.07	0.49	0.02	0.12	0.22	0.57	0.86	1.82	1.27	1.57					
7	0.03	0.05	0.05	0.09	0.17	0.47	1.19	2.08	1.09						
8	0.08	0.08	0.07	0.32	0.31	0.53	1.31	1.39							
9	0.05	0.11	0.11	0.06	0.34	0.87	0.81								
10	0.08	0.06	0.10	0.26	0.43	0.72									
11	0.12	0.15	0.17	0.07	0.34										
12	0.09	0.19	0.05	0.15											
13	0.03	0.03	0.07												
14	0.00	0.11													
15	0.00														

30-YEAR MORTGAGES (LTV RATIOS OF 75 - 85%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.02	0.00	0.00	0.00	0.00	0.00	0.08	0.04	0.01	0.01	0.02	0.00	0.03	0.01	0.01
2	0.14	0.25	0.03	0.13	0.07	0.29	0.78	1.50	0.25	0.44	0.50	0.28	0.34	0.34	
3	0.38	0.24	0.12	0.17	0.44	0.65	2.12	2.69	0.85	1.68	1.85	1.23	0.80		
4	0.23	0.49	0.18	0.18	0.33	0.87	2.36	3.10	1.28	2.79	3.84	1.42			
5	0.23	0.30	0.11	0.26	0.42	0.74	2.06	2.85	2.01	4.30	3.42				
6	0.14	0.17	0.12	0.18	0.33	0.78	1.85	4.07	3.10	3.84					
7	0.13	0.08	0.07	0.22	0.28	0.79	2.52	4.24	2.74						
8	0.07	0.12	0.07	0.18	0.47	1.01	3.05	2.39							
9	0.12	0.04	0.12	0.14	0.42	1.55	1.91								
10	0.07	0.15	0.10	0.22	0.39	1.62									
11	0.05	0.10	0.12	0.32	0.43										
12	0.06	0.10	0.13	0.20											
13	0.08	0.04	0.09												
14	0.16	0.05													
15	0.00														

30-YEAR MORTGAGES (LTV RATIOS OF 85 - 90%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.02	0.02	0.01	0.01	0.00	0.00	0.03	0.06	0.02	0.02	0.02	0.01	0.01	0.01	0.01
2	0.22	0.34	0.23	0.17	0.17	0.41	0.85	1.14	0.30	0.69	0.56	0.30	0.22	0.25	
3	0.42	0.45	0.39	0.31	0.55	0.83	2.03	2.64	1.05	2.49	2.71	1.31	0.74		
4	0.44	0.42	0.20	0.32	0.37	1.07	2.05	3.59	1.64	4.16	5.32	1.83			
5	0.35	0.36	0.15	0.23	0.49	1.03	2.35	4.00	2.74	5.63	4.58				
6	0.26	0.20	0.14	0.25	0.41	0.92	2.40	5.44	3.99	4.51					
7	0.14	0.16	0.17	0.25	0.43	1.08	3.26	5.27	3.23						
8	0.16	0.20	0.10	0.16	0.44	1.51	4.11	3.31							
9	0.11	0.13	0.07	0.28	0.67	1.86	2.88								
10	0.15	0.08	0.12	0.30	0.94	1.63									
11	0.05	0.18	0.12	0.49	0.83										
12	0.09	0.05	0.22	0.35											
13	0.07	0.24	0.17												
14	0.15	0.21													
15	0.13														

30-YEAR MORTGAGES (LTV RATIO OF 90 - 93%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY															
YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.05	0.05	0.00	0.04	0.00	0.01	0.05	0.08	0.02	0.06	0.03	0.01	0.01	0.01	0.01
2	0.36	0.40	0.23	0.24	0.33	0.63	1.08	1.74	0.71	0.83	0.69	0.35	0.29	0.32	
3	0.71	0.49	0.38	0.39	0.79	1.16	2.56	4.27	1.73	2.27	2.61	1.53	0.92		
4	0.59	0.47	0.28	0.37	0.76	1.49	2.38	4.54	2.25	4.16	5.00	2.14			
5	0.46	0.30	0.23	0.33	0.74	1.35	2.84	4.90	3.45	6.28	5.17				
6	0.37	0.22	0.17	0.30	0.77	1.37	3.01	6.89	4.83	5.32					
7	0.26	0.18	0.22	0.26	0.70	1.36	4.27	6.33	3.91						
8	0.11	0.25	0.15	0.31	0.65	1.81	4.48	4.43							
9	0.13	0.13	0.17	0.33	0.77	1.93	2.84								
10	0.13	0.07	0.16	0.35	0.97	1.81									
11	0.10	0.11	0.16	0.45	0.83										
12	0.15	0.14	0.27	0.29											
13	0.15	0.15	0.18												
14	0.14	0.20													
15	0.14														

30-YEAR MORTGAGES (LTV RATIO OF 93 - 95%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.03	0.01	0.02	0.04	0.05	0.02	0.06	0.16	0.03	0.06	0.03	0.03	0.01	0.01	0.01
2	0.49	0.53	0.36	0.35	0.39	0.72	1.38	2.36	0.60	1.32	0.99	0.53	0.36	0.37	
3	0.82	0.67	0.60	0.50	0.87	1.40	3.48	4.88	2.20	3.35	3.69	2.00	1.13		
4	0.80	0.62	0.43	0.53	0.78	1.78	3.50	6.01	3.16	5.70	6.39	2.53			
5	0.57	0.45	0.36	0.40	0.82	1.71	3.52	7.25	4.55	7.49	5.93				
6	0.38	0.31	0.24	0.53	0.89	1.71	3.60	8.20	6.38	6.04					
7	0.29	0.26	0.30	0.46	0.84	1.80	4.45	8.68	5.09						
8	0.21	0.28	0.24	0.46	0.95	2.18	5.34	5.30							
9	0.29	0.26	0.22	0.35	1.14	2.71	4.10								
10	0.21	0.23	0.24	0.50	1.20	2.16									
11	0.27	0.18	0.28	0.62	1.02										
12	0.17	0.26	0.38	0.52											
13	0.21	0.34	0.34												
14	0.17	0.26													
15	0.21														

30-YEAR MORTGAGES (LTV RATIOS OF 95 - 97%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.09	0.18	0.08	0.04	0.03	0.05	0.21	0.26	0.05	0.06	0.04	0.02	0.01	0.01	0.01
2	1.11	1.22	0.72	0.54	0.61	1.25	2.46	3.98	1.10	1.78	1.27	0.70	0.52	0.49	
3	1.65	1.27	0.87	0.85	1.15	2.12	5.40	6.68	3.09	4.29	4.31	2.36	1.44		
4	1.27	0.95	0.64	0.66	1.03	2.45	4.66	7.90	3.95	6.54	7.12	2.97			
5	0.85	0.52	0.47	0.52	1.17	2.18	4.84	8.07	5.22	8.64	6.60				
6	0.46	0.36	0.39	0.62	0.99	2.11	4.28	8.15	6.78	6.83					
7	0.33	0.32	0.45	0.53	1.01	2.02	4.84	8.18	5.27						
8	0.26	0.33	0.34	0.50	1.07	2.45	5.24	4.90							
9	0.36	0.36	0.37	0.59	1.19	2.83	4.03								
10	0.29	0.28	0.38	0.57	1.47	2.33									
11	0.29	0.30	0.40	0.83	1.36										
12	0.27	0.33	0.56	0.84											
13	0.29	0.44	0.57												
14	0.44	0.41													
15	0.41														

30-YEAR MORTGAGES (LTV RATIOS GREATER THAN OR EQUAL TO 97%)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.13	0.30	0.15	0.04	0.13	0.15	0.37	1.21	0.07	0.07	0.07	0.04	0.03	0.03	0.07
2	2.11	2.49	1.39	1.07	1.70	2.69	5.52	8.79	1.43	1.92	1.73	1.04	0.92	0.94	
3	2.38	2.13	1.31	0.92	2.14	3.74	8.50	12.42	4.27	4.58	5.68	3.48	2.25		
4	1.36	1.20	0.80	1.01	1.65	3.56	6.10	10.81	4.47	6.62	8.00	3.81			
5	0.68	0.63	0.65	0.78	1.68	2.75	5.35	11.32	6.06	8.02	6.77				
6	0.44	0.47	0.45	0.78	1.31	2.67	5.07	9.41	7.17	6.44					
7	0.33	0.47	0.41	0.53	1.36	2.55	5.28	6.65	5.84						
8	0.24	0.41	0.30	0.66	1.26	2.48	5.98	7.31							
9	0.32	0.29	0.41	0.52	1.26	3.24	5.24								
10	0.28	0.25	0.34	0.65	1.77	2.86									
11	0.25	0.33	0.43	0.78	1.41										
12	0.21	0.23	0.52	0.92											
13	0.27	0.46	0.69												
14	0.25	0.67													
15	0.36														

30-YEAR MORTGAGES (LTV CATEGORY: INVESTOR)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.01	0.00	0.05	0.01	0.00	0.01	0.04	0.16	0.01	0.02	0.03	0.01	0.01	0.01	0.02
2	0.25	0.45	0.33	0.26	0.30	0.48	1.82	2.92	0.64	1.25	1.39	0.66	0.32	0.30	
3	0.76	0.92	0.51	0.46	0.69	1.12	4.28	5.71	1.92	3.56	4.39	2.30	1.08		
4	0.83	0.87	0.51	0.58	0.67	1.60	4.10	6.12	2.65	5.21	7.49	2.63			
5	0.79	0.67	0.34	0.42	0.75	1.51	3.93	6.25	3.48	6.92	6.22				
6	0.93	0.44	0.36	0.50	0.69	1.64	3.60	6.14	4.66	7.93					
7	0.48	0.39	0.24	0.39	0.80	1.41	3.82	5.09	5.66						
8	0.26	0.34	0.29	0.43	0.56	1.44	3.69	4.21							
9	0.47	0.23	0.24	0.33	0.67	1.85	2.52								
10	0.24	0.22	0.21	0.36	1.01	1.70									
11	0.29	0.23	0.26	0.50	0.77										
12	0.27	0.30	0.31	0.41											
13	0.18	0.35	0.22												
14	0.29	0.22													
15	0.32														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 1)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.13	0.32	0.16	0.10	0.08	0.08	0.24	0.35	0.07	0.09	0.07	0.02	0.02	0.02	0.04
2	1.80	2.39	1.52	1.22	1.20	1.57	2.62	3.37	1.07	1.80	1.45	0.84	0.53	0.65	
3	2.45	2.21	1.61	1.48	1.74	2.47	4.92	5.53	2.66	4.11	4.09	2.47	1.52		
4	1.91	1.61	1.22	1.34	1.50	2.74	3.93	5.79	3.06	5.35	5.43	2.78			
5	1.34	1.00	0.90	1.12	1.63	2.18	3.62	5.65	3.52	6.04	4.89				
6	0.84	0.69	0.68	1.03	1.22	2.21	3.43	5.13	4.27	4.96					
7	0.61	0.63	0.74	0.91	1.23	1.88	3.75	5.74	3.49						
8	0.59	0.65	0.50	0.77	1.16	2.12	4.44	4.37							
9	0.68	0.62	0.63	0.80	1.38	2.23	3.59								
10	0.61	0.46	0.56	0.93	1.64	2.37									
11	0.61	0.58	0.66	1.18	1.54										
12	0.68	0.57	0.91	1.24											
13	0.61	0.84	0.92												
14	0.90	0.85													
15	0.88														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 2)

CONDITIONAL CLAIM PROBABILITY (X)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.15	0.23	0.07	0.05	0.02	0.02	0.12	0.19	0.03	0.04	0.05	0.02	0.01	0.01	0.02
2	1.45	1.55	0.77	0.62	0.61	1.05	1.98	2.67	0.78	1.50	1.19	0.61	0.47	0.58	
3	1.80	1.52	0.82	0.75	1.30	1.80	3.98	4.98	2.19	3.53	3.76	2.16	1.38		
4	1.35	1.02	0.55	0.76	1.02	1.92	3.17	5.71	2.72	4.88	5.42	2.52			
5	0.89	0.61	0.44	0.55	1.15	1.64	3.27	5.28	3.54	6.30	5.23				
6	0.50	0.43	0.44	0.80	1.00	1.61	3.08	6.10	4.66	6.09					
7	0.43	0.45	0.49	0.60	0.97	1.53	3.58	5.68	4.02						
8	0.32	0.44	0.36	0.60	0.97	1.92	3.85	4.62							
9	0.44	0.36	0.41	0.59	1.02	2.29	2.89								
10	0.38	0.34	0.35	0.57	1.21	1.90									
11	0.40	0.38	0.37	0.77	1.22										
12	0.33	0.34	0.53	0.67											
13	0.34	0.53	0.47												
14	0.37	0.50													
15	0.43														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 3)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.07	0.09	0.05	0.03	0.02	0.03	0.07	0.08	0.01	0.05	0.03	0.01	0.02	0.01	0.01
2	0.97	0.90	0.53	0.44	0.45	0.94	1.35	2.12	0.54	1.40	1.00	0.52	0.40	0.48	
3	1.29	1.04	0.62	0.62	0.93	1.58	3.30	3.85	1.60	3.59	3.47	1.90	1.13		
4	0.82	0.74	0.40	0.54	0.86	1.88	3.26	5.03	2.25	4.95	6.01	2.40			
5	0.64	0.40	0.38	0.44	0.97	1.60	3.07	5.46	3.26	6.46	5.28				
6	0.38	0.30	0.27	0.47	0.85	1.47	3.16	5.16	4.33	5.81					
7	0.21	0.29	0.35	0.38	0.84	1.58	3.53	5.40	3.77						
8	0.23	0.31	0.27	0.50	0.87	1.80	4.03	3.32							
9	0.31	0.24	0.29	0.51	0.91	2.20	2.68								
10	0.18	0.21	0.30	0.48	1.24	1.93									
11	0.16	0.19	0.28	0.70	1.01										
12	0.20	0.25	0.34	0.62											
13	0.21	0.31	0.40												
14	0.29	0.35													
15	0.20														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 4)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.04	0.04	0.02	0.02	0.01	0.02	0.08	0.08	0.02	0.03	0.02	0.02	0.01	0.01	0.00
2	0.63	0.60	0.29	0.28	0.36	0.70	1.49	1.94	0.47	1.10	1.00	0.52	0.36	0.37	
3	1.11	0.76	0.52	0.47	0.82	1.26	3.52	4.46	1.69	3.01	3.45	1.78	1.06		
4	0.85	0.59	0.37	0.46	0.75	1.53	3.22	4.78	2.26	5.05	5.89	2.18			
5	0.52	0.33	0.27	0.32	0.83	1.44	3.52	5.35	3.24	7.04	5.41				
6	0.31	0.31	0.22	0.40	0.79	1.36	3.19	6.54	4.96	5.80					
7	0.31	0.22	0.24	0.33	0.71	1.44	3.58	6.77	4.32						
8	0.16	0.20	0.20	0.36	0.84	1.72	3.85	3.94							
9	0.22	0.20	0.16	0.40	0.96	2.14	3.33								
10	0.15	0.17	0.24	0.43	1.16	1.72									
11	0.17	0.18	0.23	0.54	0.95										
12	0.13	0.18	0.34	0.52											
13	0.11	0.18	0.30												
14	0.21	0.23													
15	0.20														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 5)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.03	0.03	0.01	0.02	0.02	0.01	0.03	0.05	0.02	0.03	0.02	0.01	0.01	0.01	0.01
2	0.45	0.42	0.22	0.17	0.26	0.49	1.40	2.26	0.53	1.02	0.94	0.40	0.34	0.34	
3	0.80	0.54	0.45	0.35	0.63	1.03	3.29	4.68	1.70	2.80	3.21	1.68	0.97		
4	0.73	0.57	0.31	0.30	0.57	1.38	2.63	5.44	2.45	5.30	6.23	2.12			
5	0.42	0.35	0.19	0.29	0.67	1.35	3.30	5.77	3.66	7.29	5.62				
6	0.29	0.24	0.15	0.32	0.67	1.41	3.25	8.33	5.34	6.34					
7	0.19	0.14	0.17	0.31	0.71	1.43	4.13	6.83	4.12						
8	0.10	0.19	0.14	0.33	0.82	1.67	4.91	3.99							
9	0.17	0.14	0.15	0.26	0.85	2.34	3.33								
10	0.14	0.11	0.14	0.40	1.10	1.78									
11	0.12	0.11	0.20	0.52	0.93										
12	0.08	0.14	0.21	0.42											
13	0.11	0.20	0.23												
14	0.10	0.13													
15	0.15														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 6)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.01	0.01	0.01	0.01	0.00	0.01	0.06	0.07	0.01	0.03	0.01	0.01	0.01	0.01	0.02
2	0.29	0.29	0.10	0.14	0.22	0.44	1.08	1.66	0.42	0.88	0.72	0.38	0.30	0.30	
3	0.54	0.39	0.24	0.28	0.54	0.87	3.04	3.78	1.40	2.65	3.22	1.51	0.89		
4	0.46	0.40	0.20	0.27	0.52	1.32	3.39	4.95	2.18	5.12	6.35	2.15			
5	0.33	0.29	0.15	0.18	0.57	1.28	3.49	6.44	3.66	8.15	5.90				
6	0.24	0.15	0.09	0.29	0.59	1.43	3.25	8.74	5.51	7.72					
7	0.19	0.12	0.08	0.27	0.65	1.40	4.74	7.18	5.21						
8	0.07	0.12	0.10	0.25	0.69	1.85	5.06	3.81							
9	0.10	0.10	0.08	0.26	0.92	2.40	3.07								
10	0.07	0.06	0.09	0.30	1.09	1.71									
11	0.07	0.07	0.13	0.48	0.91										
12	0.03	0.09	0.22	0.38											
13	0.08	0.13	0.14												
14	0.04	0.09													
15	0.04														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 7)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.01	0.03	0.00	0.01	0.00	0.00	0.02	0.00	0.00	0.03	0.01	0.00	0.01	0.00	0.01
2	0.14	0.20	0.07	0.14	0.15	0.23	0.75	1.45	0.31	0.56	0.48	0.26	0.24	0.17	
3	0.47	0.29	0.13	0.34	0.53	1.02	2.50	3.18	1.11	1.83	2.21	1.30	0.66		
4	0.41	0.21	0.12	0.27	0.42	1.36	3.25	3.61	1.44	3.64	5.51	1.70			
5	0.40	0.18	0.10	0.23	0.47	1.39	3.41	3.46	2.40	5.95	4.89				
6	0.19	0.09	0.08	0.23	0.56	1.28	2.98	5.04	3.40	4.25					
7	0.09	0.06	0.06	0.16	0.58	1.41	3.87	5.08	3.08						
8	0.04	0.08	0.03	0.23	0.51	1.92	4.10	2.17							
9	0.09	0.04	0.05	0.20	0.64	2.12	2.74								
10	0.08	0.02	0.08	0.19	0.81	1.74									
11	0.03	0.04	0.06	0.26	0.72										
12	0.02	0.08	0.12	0.35											
13	0.03	0.06	0.09												
14	0.02	0.06													
15	0.04														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY B)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY															
YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.03	0.00	0.05	0.02	0.00	0.00
2	0.00	0.30	0.10	0.15	0.24	0.08	0.72	1.41	0.29	1.30	1.56	1.39	0.83	0.00	
3	0.66	0.61	0.72	0.15	0.25	0.60	2.07	6.25	1.86	6.29	7.91	5.34	2.10		
4	0.75	0.49	0.11	0.31	0.76	1.46	4.29	9.11	3.78	10.78	14.62	5.35			
5	0.00	0.17	0.11	0.00	0.51	1.44	5.48	9.32	5.26	14.06	10.40				
6	0.00	0.00	0.33	0.48	0.00	1.60	4.67	9.72	9.82	9.97					
7	0.00	0.18	0.00	0.33	0.56	1.48	7.81	12.18	6.86						
8	0.00	0.00	0.23	0.17	0.57	1.74	7.61	4.55							
9	0.00	0.18	0.12	0.17	0.90	3.46	4.05								
10	0.00	0.19	0.00	0.73	1.30	1.86									
11	0.00	0.00	0.25	0.78	1.76										
12	0.00	0.59	0.13	1.43											
13	0.61	0.00	0.00												
14	0.00	0.00													
15	0.00														

15-YEAR MORTGAGES

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.00	0.00	0.00	0.01	0.01
2	0.48	0.43	0.75	1.34	0.70	0.20	1.56	0.68	0.15	0.40	0.19	0.14	0.10	0.17	
3	1.16	1.46	1.56	0.00	0.95	2.79	5.94	2.45	0.59	1.13	1.17	0.55	0.32		
4	3.35	1.88	1.03	0.28	1.21	1.03	2.18	3.21	1.03	1.74	2.15	0.68			
5	1.79	1.01	0.65	1.17	1.52	0.64	3.48	1.87	1.21	2.72	1.70				
6	2.78	1.06	0.45	0.90	1.06	0.67	0.76	0.94	1.30	1.75					
7	0.91	1.12	1.16	0.00	0.00	2.78	1.40	3.49	1.09						
8	1.42	1.57	0.50	0.65	1.41	2.57	1.88	1.78							
9	0.99	0.83	0.51	0.68	0.61	0.86	1.02								
10	0.52	0.88	1.33	0.36	1.03	0.31									
11	1.94	1.15	0.00	0.75	0.37										
12	0.00	1.47	0.31	0.79											
13	1.02	1.07	0.33												
14	0.38	0.29													
15	1.39														

GRADUATED PAYMENT MORTGAGES (GPM)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1			0.00	0.00	0.00	0.01	0.00	0.05	0.01	0.02	0.00	0.02	0.00	0.03	0.00
2			0.00	0.03	0.09	0.24	0.43	0.97	0.29	0.63	0.67	0.46	0.35	0.20	
3			0.00	0.16	0.32	0.54	1.68	3.10	1.30	2.53	2.89	1.94	0.93		
4			0.40	0.28	0.39	1.00	2.66	5.73	2.43	6.01	6.73	2.77			
5			0.00	0.30	0.61	1.23	3.88	8.47	5.29	11.49	6.75				
6			0.00	0.41	0.67	1.64	4.45	12.45	8.96	10.17					
7			0.41	0.50	0.79	1.79	6.66	12.51	7.98						
8			0.00	0.51	0.80	2.32	6.70	7.18							
9			0.43	0.42	0.97	2.77	4.18								
10			0.00	0.46	1.15	2.33									
11			0.00	0.64	1.05										
12			0.00	0.49											
13			0.00												
14															
15															

CONDITIONAL PREPAYMENT PROBABILITY

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 85% LTV RATIO)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1											0.07	0.03	0.02	0.01	
2											2.06	1.11	0.60	1.14	
3											6.86	4.34	2.00		
4											11.13	3.92			
5											9.26				
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 90% LTV RATIO)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1												0.02	0.02	0.02	0.01
2												0.42	0.66	0.79	
3												1.58	1.73		
4												2.15			
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 95% LTV RATIO)

CONDITIONAL CLAIM PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1														0.05	0.06
2														0.91	
3															
4															
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

30-YEAR MORTGAGES (LTV RATIOS LESS THAN 75%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.75	1.50	1.39	1.52	1.08	0.61	0.62	0.76	0.71	0.56	0.97	1.12	0.69	1.14	0.94
2	4.58	7.39	5.70	5.14	2.37	1.68	1.31	28.34	2.22	3.31	19.53	6.61	2.43	3.58	
3	8.80	9.85	7.75	3.54	1.71	0.83	13.18	15.21	4.25	28.62	33.02	4.49	3.23		
4	10.10	8.27	4.01	1.95	0.52	3.68	8.51	17.85	25.77	34.30	12.89	4.54			
5	8.56	4.16	2.21	0.91	2.88	3.68	9.45	36.09	34.68	13.41	9.38				
6	4.51	2.39	1.19	3.19	2.63	4.37	25.23	26.24	12.96	9.49					
7	2.10	1.48	3.09	2.50	3.21	12.97	26.66	11.98	9.16						
8	1.41	2.88	3.10	3.30	6.72	18.38	11.58	7.95							
9	3.34	3.43	3.50	6.87	10.28	8.63	7.89								
10	3.91	3.90	5.97	8.56	6.39	6.99									
11	3.49	6.25	8.28	5.84	6.42										
12	5.79	7.60	6.33	5.80											
13	8.26	6.23	5.69												
14	5.55	5.84													
15	5.21														

30-YEAR MORTGAGES (LTV RATIOS OF 75 - 85%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.49	0.80	0.87	0.98	0.44	0.56	0.17	0.48	0.33	0.31	0.46	0.76	0.46	0.69	0.71
2	3.43	5.38	5.02	4.24	1.13	1.04	0.59	23.07	1.11	2.00	16.49	5.26	1.51	2.30	
3	8.18	9.21	6.78	2.76	0.79	0.37	10.70	12.67	2.75	26.37	29.70	3.33	2.21		
4	10.30	7.87	3.55	1.37	0.37	2.29	6.74	16.17	22.18	33.37	12.17	3.48			
5	7.48	4.53	1.64	0.76	2.06	2.41	8.43	34.67	32.39	12.88	9.32				
6	4.16	2.16	0.65	2.52	1.92	3.37	25.34	27.35	12.40	9.32					
7	1.78	0.95	3.00	2.34	2.40	11.83	24.94	11.10	9.40						
8	0.88	3.07	2.78	3.04	6.15	18.06	10.75	7.36							
9	3.18	3.10	3.20	6.50	9.26	8.65	8.71								
10	3.60	3.64	6.14	8.78	6.39	6.78									
11	4.22	6.03	8.51	6.18	5.93										
12	6.10	8.31	6.07	5.00											
13	8.90	6.11	5.30												
14	5.56	5.66													
15	4.73														

30-YEAR MORTGAGES (LTV RATIOS OF 85 - 90%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.25	0.42	0.38	0.40	0.26	0.15	0.09	0.06	0.19	0.14	0.24	0.51	0.18	0.27	0.77
2	2.42	3.86	3.13	2.78	0.82	0.49	0.28	18.38	0.79	1.46	13.82	3.86	0.94	1.38	
3	6.94	8.18	5.86	2.04	0.59	0.28	7.76	9.37	2.16	23.69	27.22	2.65	1.71		
4	10.16	8.18	3.20	1.06	0.41	1.81	4.84	13.96	20.88	29.48	11.33	3.20			
5	8.78	4.12	1.48	0.59	1.48	2.23	6.69	35.04	29.53	12.20	9.17				
6	4.01	1.88	0.64	2.11	1.81	2.88	21.99	27.87	12.09	9.62					
7	2.03	0.79	2.65	2.12	2.19	10.87	21.35	10.22	9.28						
8	0.69	2.96	2.79	2.44	5.43	16.14	9.40	7.65							
9	2.82	2.72	3.07	5.91	8.39	7.76	6.43								
10	3.20	3.50	6.09	8.33	6.33	6.25									
11	3.55	6.83	8.71	6.32	5.56										
12	6.51	8.51	6.26	5.59											
13	8.16	6.17	5.82												
14	6.14	5.33													
15	5.13														

30-YEAR MORTGAGES (LTV RATIOS OF 90 - 93%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.14	0.20	0.29	0.37	0.21	0.13	0.06	0.07	0.11	0.12	0.14	0.37	0.11	0.20	0.26
2	1.80	3.68	3.13	2.42	0.59	0.39	0.21	13.86	0.55	1.29	10.83	3.11	0.64	1.07	
3	7.00	8.07	5.94	1.94	0.54	0.26	6.77	7.66	1.65	20.52	26.38	2.33	1.43		
4	9.74	9.05	3.22	1.14	0.36	1.61	4.19	11.46	17.45	27.52	10.82	2.94			
5	8.71	4.34	1.50	0.65	1.18	1.82	5.61	32.33	26.48	12.07	8.24				
6	4.35	2.11	0.63	1.91	1.59	2.64	20.50	25.18	10.80	8.92					
7	1.89	0.75	2.60	1.95	1.95	9.70	21.40	11.01	8.63						
8	0.79	3.15	2.79	2.24	5.41	15.23	9.12	6.77							
9	3.28	3.53	3.03	5.81	8.59	7.81	6.81								
10	3.26	3.75	6.50	8.61	5.82	5.93									
11	3.78	6.91	8.46	6.13	5.36										
12	6.40	9.33	6.41	5.18											
13	8.44	6.56	5.43												
14	6.37	5.76													
15	5.60														

30-YEAR MORTGAGES (LTV RATIOS OF 93 - 95%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.16	0.16	0.30	0.32	0.20	0.09	0.12	0.13	0.11	0.09	0.12	0.28	0.11	0.16	0.24
2	1.72	3.34	3.26	2.33	0.60	0.32	0.25	11.71	0.45	0.79	9.22	2.72	0.55	1.05	
3	7.17	8.96	6.36	1.91	0.47	0.26	5.03	5.93	1.34	16.93	21.28	2.10	1.32		
4	11.01	9.70	3.53	1.18	0.29	1.37	3.51	9.59	14.25	24.41	9.98	2.75			
5	9.67	4.71	1.70	0.64	1.21	1.53	4.96	29.31	22.74	10.62	8.14				
6	4.37	2.38	0.65	1.87	1.43	2.14	17.73	23.86	9.34	8.54					
7	2.32	0.87	2.61	2.06	1.84	8.48	18.87	10.39	7.65						
8	1.16	3.35	2.78	2.29	4.80	12.57	8.35	8.00							
9	3.23	3.29	3.28	5.31	7.15	6.57	6.04								
10	3.50	3.77	6.04	7.84	5.31	5.19									
11	3.64	6.58	7.99	5.63	4.85										
12	5.93	8.46	5.87	5.24											
13	8.14	5.83	5.51												
14	6.08	5.58													
15	5.03														

30-YEAR MORTGAGES (LTV RATIOS OF 95 - 97%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.12	0.19	0.29	0.20	0.19	0.18	0.09	0.10	0.11	0.11	0.14	0.25	0.13	0.20	0.28
2	1.51	2.99	3.13	2.14	0.69	0.47	0.24	10.87	0.35	0.75	8.18	2.59	0.64	1.11	
3	6.61	8.68	6.48	2.03	0.63	0.27	5.02	6.24	1.28	15.09	19.79	2.21	1.42		
4	10.08	9.52	3.94	1.39	0.34	1.39	3.25	8.70	13.23	23.10	10.44	2.97			
5	9.58	5.32	2.11	0.77	1.21	1.61	4.46	21.79	21.49	11.26	8.87				
6	5.04	2.71	0.85	1.91	1.48	2.12	16.54	24.54	9.88	9.63					
7	2.72	1.07	2.68	2.00	1.83	7.42	18.16	11.38	7.89						
8	1.30	3.42	2.68	2.33	4.22	11.59	8.79	8.00							
9	3.57	3.41	3.12	5.00	6.92	6.33	6.65								
10	3.34	3.49	5.39	7.09	5.14	5.33									
11	3.59	5.52	6.95	5.28	4.89										
12	5.80	7.29	5.25	4.95											
13	7.19	5.43	4.76												
14	5.28	4.86													
15	4.92														

30-YEAR MORTGAGES (LTV RATIOS GREATER THAN OR EQUAL TO 97%)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.12	0.24	0.27	0.18	0.33	0.09	0.20	0.33	0.17	0.11	0.15	0.24	0.19	0.43	0.77
2	1.48	2.96	2.99	2.27	0.86	0.53	0.45	8.79	0.41	0.66	7.79	2.42	0.95	1.52	
3	6.72	8.38	6.34	2.04	0.89	0.22	3.11	4.68	1.18	12.44	17.09	1.95	1.30		
4	10.91	9.42	3.88	1.47	0.32	1.02	2.37	7.45	11.44	18.92	8.49	2.42			
5	10.02	5.30	2.09	0.94	1.54	1.51	3.32	15.23	17.66	9.28	6.91				
6	5.19	2.73	1.01	1.97	1.35	1.94	9.20	12.69	7.43	8.05					
7	2.89	1.29	3.08	2.02	1.69	6.21	11.99	9.46	7.44						
8	1.50	3.46	2.60	2.11	4.19	8.80	5.93	3.97							
9	3.71	3.28	2.91	4.54	5.71	4.59	4.26								
10	3.55	3.43	5.16	6.86	4.35	4.07									
11	3.29	5.56	6.21	5.03	4.04										
12	5.34	6.77	4.93	4.69											
13	7.17	5.30	4.28												
14	5.28	4.65													
15	5.02														

30-YEAR MORTGAGES (LTV CATEGORY: INVESTOR)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.36	0.39	0.41	0.51	0.51	1.43	0.18	0.76	0.40	0.29	0.34	0.72	0.33	0.68	0.58
2	1.86	3.13	2.83	2.53	1.15	3.76	0.48	19.18	1.22	1.91	10.94	4.57	1.24	1.96	
3	4.97	6.40	4.87	2.07	0.88	0.50	7.49	11.29	2.40	16.96	23.74	3.09	1.91		
4	7.07	6.32	2.51	1.42	0.46	1.96	5.87	12.30	13.62	26.05	11.08	3.22			
5	6.38	3.37	1.86	0.95	1.83	2.53	6.45	22.59	24.55	11.81	8.42				
6	3.18	2.04	1.08	1.96	2.16	3.07	17.44	22.33	10.75	9.49					
7	2.10	1.25	2.39	2.45	2.86	9.20	22.22	12.30	7.94						
8	1.31	2.87	3.13	2.85	4.79	14.46	12.02	8.20							
9	3.05	3.75	3.38	4.77	7.37	8.52	8.43								
10	3.34	3.41	5.31	7.39	5.76	6.21									
11	3.65	5.98	7.49	5.93	5.67										
12	5.06	7.28	5.61	4.98											
13	6.79	6.22	4.87												
14	5.30	5.61													
15	5.64														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 1)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.23	0.34	0.44	0.47	0.53	0.25	0.25	0.45	0.39	0.27	0.33	0.42	0.32	0.39	0.37
2	1.79	2.75	2.94	2.70	1.40	0.86	0.67	11.77	1.41	1.40	5.52	2.73	1.04	1.39	
3	5.00	6.50	5.56	2.55	1.30	0.67	4.69	7.27	2.53	8.69	11.11	2.46	1.62		
4	7.47	7.28	4.04	2.08	0.81	2.33	4.09	8.02	9.67	12.86	5.95	2.90			
5	7.50	4.94	2.73	1.33	2.21	2.60	4.42	17.63	13.52	6.44	5.38				
6	4.27	3.13	1.42	2.61	2.32	2.77	11.02	16.61	6.73	5.69					
7	3.02	1.76	3.06	2.61	2.68	5.27	11.94	9.07	5.88						
8	1.88	3.47	3.02	2.75	3.85	7.22	6.65	6.71							
9	3.71	3.54	3.19	3.98	4.84	4.96	5.25								
10	3.53	3.47	4.29	4.81	4.10	3.91									
11	3.86	4.52	4.96	4.05	3.81										
12	4.54	5.11	4.14	3.57											
13	5.03	4.37	3.63												
14	4.22	3.79													
15	3.97														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 2)

CONDITIONAL PRE-PAYMENT PROBABILITY (X)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.27	0.32	0.41	0.43	0.35	0.31	0.15	0.43	0.30	0.23	0.23	0.39	0.26	0.34	0.36
2	1.93	3.64	3.36	2.99	1.04	0.78	0.44	17.36	1.11	1.32	8.30	2.95	1.01	1.23	
3	6.72	8.83	6.51	2.44	0.96	0.34	6.00	9.28	2.48	13.56	17.18	2.38	1.63		
4	10.02	9.23	3.87	1.51	0.38	1.93	4.74	10.50	13.95	19.91	8.38	2.79			
5	9.32	5.47	2.25	0.76	1.73	2.18	5.39	24.80	19.85	9.15	6.86				
6	4.89	2.88	0.93	2.25	1.96	2.94	15.99	21.05	9.04	7.59					
7	2.90	1.20	2.92	2.23	2.21	7.14	17.21	10.83	7.42						
8	1.49	3.30	2.92	2.77	4.43	10.14	8.50	7.97							
9	3.68	3.69	3.18	4.58	6.19	6.25	6.15								
10	3.55	3.69	5.17	6.29	4.93	5.23									
11	3.82	5.08	6.56	4.64	4.48										
12	5.11	6.69	4.91	4.42											
13	6.28	5.17	4.35												
14	4.62	4.90													
15	4.63														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 3)

CONDITIONAL PRE-PAYMENT PROBABILITY (X)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.24	0.25	0.34	0.37	0.31	0.31	0.16	0.28	0.29	0.16	0.33	0.46	0.25	0.36	0.37
2	2.00	3.05	3.22	2.69	0.91	0.84	0.34	18.10	1.02	1.35	10.02	3.35	0.94	1.20	
3	7.45	8.32	6.27	2.47	0.69	0.33	6.50	8.97	2.40	16.95	20.55	2.43	1.53		
4	11.02	9.99	3.84	1.37	0.29	1.68	4.26	11.47	17.13	24.08	9.42	2.88			
5	9.74	5.21	1.90	0.65	1.42	2.13	5.58	25.75	25.45	11.10	7.72				
6	4.91	2.57	0.76	2.15	1.58	2.56	17.17	32.00	10.28	8.58					
7	2.51	1.03	2.77	2.20	2.23	8.23	19.58	13.48	8.11						
8	1.17	3.31	2.73	2.64	4.64	11.70	9.29	7.46							
9	3.45	3.17	3.06	4.98	7.02	6.51	6.91								
10	3.38	3.62	5.47	7.07	5.37	5.73									
11	3.60	6.24	6.86	5.30	5.04										
12	5.50	7.27	5.52	4.90											
13	7.20	5.80	4.84												
14	5.54	5.02													
15	4.90														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 4)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.20	0.29	0.32	0.32	0.28	0.37	0.11	0.34	0.26	0.20	0.32	0.49	0.24	0.33	0.42
2	1.93	3.24	3.27	2.66	0.78	0.96	0.34	20.23	0.95	1.40	11.87	3.61	0.95	1.27	
3	7.39	8.98	6.17	2.14	0.50	0.25	6.88	10.26	2.22	20.30	24.01	2.48	1.44		
4	10.90	9.83	3.41	1.16	0.28	1.59	4.22	12.98	18.24	27.99	10.71	2.85			
5	9.56	4.93	1.69	0.52	1.28	1.96	5.66	31.20	27.30	12.39	8.11				
6	4.87	2.38	0.66	1.78	1.61	2.62	18.94	25.57	10.76	9.52					
7	2.43	0.84	2.47	2.00	2.12	8.90	21.76	11.95	8.36						
8	1.15	3.46	2.70	2.23	5.06	13.52	10.00	8.86							
9	3.47	3.23	3.16	5.40	7.62	7.12	6.95								
10	3.34	3.65	6.04	7.32	5.62	6.02									
11	3.49	6.00	7.98	5.44	4.97										
12	5.79	7.95	5.88	4.81											
13	7.87	6.13	5.23												
14	5.78	5.63													
15	5.14														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 5)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.17	0.25	0.30	0.37	0.23	0.43	0.15	0.40	0.26	0.23	0.27	0.50	0.26	0.31	0.44
2	1.85	3.46	3.20	2.60	0.73	1.05	0.34	20.08	0.71	1.42	13.22	4.00	5.98	1.28	
3	6.79	9.29	6.55	2.04	0.49	0.28	7.98	10.91	2.09	22.93	26.46	2.52	1.49		
4	10.29	9.40	3.52	1.19	0.20	1.58	4.82	13.98	19.82	30.62	11.71	2.76			
5	9.76	4.67	1.38	0.57	1.15	1.65	6.11	35.21	29.37	13.08	8.88				
6	4.66	2.22	0.52	1.94	1.36	2.69	22.27	27.19	11.75	11.31					
7	2.22	0.78	2.44	1.93	1.83	10.28	23.82	11.77	9.02						
8	0.94	3.13	2.59	2.25	4.98	16.37	10.79	7.98							
9	3.27	3.06	3.17	5.84	8.29	7.77	8.35								
10	3.40	3.65	6.22	8.22	5.41	5.92									
11	3.39	6.52	8.32	5.96	5.50										
12	6.21	8.70	6.22	5.43											
13	8.57	5.92	5.91												
14	6.56	5.84													
15	5.49														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 6)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.15	0.21	0.37	0.34	0.16	0.41	0.16	0.26	0.24	0.17	0.27	0.57	0.23	0.29	0.53
2	1.75	3.77	3.60	2.31	0.44	1.08	0.34	18.87	0.76	1.36	14.31	4.18	0.97	1.50	
3	6.93	9.08	6.67	1.71	0.39	0.25	8.37	9.65	2.01	24.60	29.41	2.70	1.80		
4	10.17	9.17	3.23	0.98	0.25	1.46	4.72	15.06	21.17	33.31	12.99	3.20			
5	9.00	4.30	1.44	0.69	1.03	1.66	6.72	38.06	32.28	14.27	10.06				
6	4.21	1.74	0.57	1.61	1.26	2.28	25.10	29.31	12.59	11.60					
7	1.83	0.69	2.66	1.78	1.57	11.48	27.71	11.09	9.47						
8	0.80	3.08	2.77	2.11	5.31	18.25	11.81	8.31							
9	2.99	3.40	3.21	6.13	9.08	8.70	8.66								
10	3.20	3.44	6.79	9.19	6.18	6.82									
11	3.63	7.07	9.55	6.49	5.78										
12	6.70	9.72	6.59	6.00											
13	8.71	6.64	6.01												
14	6.19	5.81													
15	5.72														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 7)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.18	0.40	0.34	0.08	0.08	0.41	0.07	0.19	0.19	0.08	0.23	0.52	0.23	0.34	0.54
2	2.13	5.08	3.61	0.89	0.28	0.74	0.27	18.74	0.64	1.44	13.96	4.52	1.36	2.09	
3	7.61	8.23	5.65	0.79	0.29	0.24	11.12	10.72	1.85	25.23	33.03	3.76	2.82		
4	10.85	8.20	2.38	0.89	0.22	1.98	7.29	17.41	21.79	39.05	16.65	4.64			
5	8.33	3.43	1.35	0.81	0.96	2.12	9.68	41.21	36.74	19.98	14.03				
6	4.00	2.09	0.67	1.61	1.26	3.24	30.88	35.00	16.87	15.48					
7	1.95	0.66	2.77	1.76	1.54	15.65	32.82	16.81	12.21						
8	0.72	3.11	2.58	2.02	5.59	25.66	16.44	9.82							
9	2.91	3.43	2.72	6.07	10.22	12.31	10.91								
10	3.58	3.86	6.71	11.25	7.16	8.58									
11	3.57	7.97	10.54	8.03	6.98										
12	6.96	10.86	7.75	7.08											
13	9.97	7.27	6.59												
14	6.62	6.80													
15	5.70														

30-YEAR MORTGAGES (LOAN SIZE CATEGORY 8)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.00	0.15	0.20	0.00	0.00	0.25	0.12	0.75	0.29	0.27	0.55	1.31	0.30	0.88	1.24
2	4.11	2.07	2.61	0.61	2.17	1.09	0.60	27.52	0.77	2.50	14.80	5.58	1.72	4.65	
3	10.89	6.21	2.58	1.68	1.98	0.26	12.77	18.45	1.81	21.07	28.29	3.55	2.97		
4	9.70	4.55	1.18	2.03	0.00	3.35	12.29	17.00	15.62	32.20	13.14	3.92			
5	11.25	1.71	2.27	1.12	4.58	2.53	10.10	23.01	30.69	19.20	10.91				
6	2.82	2.44	0.89	1.94	3.75	3.10	27.79	27.13	14.25	13.93					
7	3.38	0.18	1.23	1.66	1.95	13.41	33.03	17.31	11.23						
8	2.00	1.97	2.05	1.69	4.00	21.21	17.26	8.18							
9	5.61	1.83	2.67	4.99	6.89	7.67	4.73								
10	4.32	1.12	4.90	5.63	6.49	5.58									
11	4.52	4.17	6.42	4.46	4.23										
12	2.96	6.32	5.80	3.48											
13	9.15	4.03	4.73												
14	4.73	4.87													
15	4.26														

15-YEAR MORTGAGES

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1	0.63	0.28	0.56	0.27	0.23	0.00	0.19	0.54	0.21	0.29	0.27	0.55	0.43	0.50	0.53
2	2.72	2.28	2.45	2.14	0.47	1.38	0.19	10.46	1.08	1.42	9.79	4.59	1.72	1.83	
3	5.12	4.83	3.70	2.50	1.42	0.40	3.17	7.19	2.28	12.44	21.22	4.12	2.80		
4	7.92	5.63	3.29	2.28	3.39	2.47	3.92	6.09	10.44	21.10	8.66	4.69			
5	5.36	3.72	3.01	1.17	2.79	3.85	4.64	18.66	20.81	9.30	7.21				
6	3.21	4.26	3.57	3.59	3.45	2.91	9.09	11.74	9.78	7.39					
7	2.73	3.18	4.88	3.13	1.67	6.96	8.96	5.91	8.52						
8	2.83	4.50	3.22	4.85	6.50	8.25	5.94	6.82							
9	4.43	4.58	3.08	4.45	9.82	6.92	6.78								
10	5.47	3.30	5.60	3.61	6.16	4.38									
11	5.26	5.29	6.30	3.76	4.80										
12	11.94	6.63	7.65	4.72											
13	10.17	8.29	8.64												
14	17.18	10.62													
15	25.93														

GRADUATED PAYMENT MORTGAGES (GPM)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1			0.00	0.02	0.08	0.09	0.22	0.21	0.18	0.12	0.41	0.98	0.15	0.43	0.12
2			0.40	0.63	0.33	0.32	0.49	22.28	0.57	1.57	12.84	7.16	1.16	1.92	
3			0.80	0.86	0.92	0.23	13.15	10.58	1.95	24.32	24.53	5.59	3.09		
4			0.40	0.93	0.66	1.45	7.22	15.45	19.80	28.98	14.57	6.42			
5			0.41	1.57	0.95	1.69	10.61	31.38	27.44	16.80	13.49				
6			0.82	1.54	1.09	2.59	31.52	25.43	14.03	13.85					
7			2.47	1.75	1.46	13.66	29.70	14.06	9.77						
8			0.85	1.91	4.88	20.40	13.81	8.81							
9			2.99	5.77	9.27	9.63	9.58								
10			7.96	9.60	6.94	7.66									
11			10.10	7.22	6.48										
12			8.56	7.10											
13			5.26												
14															
15															

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 85% LTV RATIO)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1											0.42	0.74	0.39	1.60	
2											8.12	4.09	1.65	5.29	
3											21.08	2.32	1.75		
4											9.65	2.70			
5											7.17				
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

SPECIAL CASE: - 30-YEAR MORTGAGES (EXACTLY 90% LTV RATIO)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1												0.24	0.19	0.34	0.41
2												2.26	0.69	1.32	
3												2.34	1.38		
4												2.89			
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 95% LTV RATIO)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1														0.75	1.11
2														2.41	
3															
4															
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

GRADUATED PAYMENT MORTGAGES (GPM)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY															
YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1			0.00	0.02	0.08	0.09	0.22	0.21	0.18	0.12	0.41	0.98	0.15	0.43	0.12
2			0.40	0.63	0.33	0.32	0.49	22.28	0.57	1.57	12.84	7.16	1.16	1.92	
3			0.80	0.86	0.52	0.23	13.15	10.58	1.95	24.32	24.53	5.59	3.09		
4			0.40	0.93	0.66	1.45	7.22	15.45	19.80	28.98	14.57	6.42			
5			0.41	1.57	0.95	1.69	10.61	31.38	27.44	16.80	13.49				
6			0.82	1.54	1.09	2.59	31.52	25.43	14.03	13.85					
7			2.47	1.75	1.46	13.66	29.70	14.06	9.77						
8			0.85	1.91	4.88	20.40	13.81	8.81							
9			2.99	5.77	9.27	9.63	9.58								
10			7.96	9.60	6.94	7.66									
11			10.10	7.22	6.48										
12			8.56	7.10											
13			5.26												
14															
15															

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 85% LTV RATIO)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1											0.42	0.74	0.39	1.60	
2											6.12	4.09	1.65	5.29	
3											21.08	2.32	1.75		
4											9.65	2.70			
5											7.17				
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 90% LTV RATIO)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

POLICY YEAR	FISCAL YEAR (AMORTIZATION OF LOAN)														
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1												0.24	0.19	0.34	0.41
2												2.26	0.69	1.32	
3												2.34	1.38		
4												2.89			
5															
6															
7															
8															
9															
10															
11															
12															
13															
14															
15															

APPENDIX D

MMI FUND ANALYSIS

APPENDIX D: ANALYSIS OF THE REVISION TO THE CONSTANT QUALITY HOUSE PRICE INDEX

On May 3, 1990 the Bureau of the Census released a new price index for new one-family houses sold, commonly referred to as the constant quality house price index. This new price index reflects changes in the specification of the statistical regression model for each of four Census regions and changes in the regional weights used in calculating a national constant quality house price index. The changes in the reported numbers are significant. For the period from 1975 through 1989, the revised price index increases by 150 percent rather than 135 percent reported earlier. However, the variability of house price appreciation across regions has diminished. These two observed changes give rise to the possibility that had our economic and financial analysis of the MMI Fund been based on this index, our conclusions regarding the soundness of the Fund and needed changes in the insurance structure would be different. To assess the effect of the new price index, we have re-computed the equity and dispersion variables for the claims analysis, re-estimated the conditional claim rate model, developed new simulation and forecasts of claim termination and re-computed the financial impact on the MMI Fund for the consensus economic scenario. The results of our analysis are reported below.

I. REVISIONS TO THE CENSUS CONSTANT QUALITY HOUSE PRICE INDEX

The Census now employs five multiplicative models to estimate indexes for detached homes in each of four Census regions and a national index for attached homes. This statistical modeling approach replaces the previous additive model. In developing the national price index, weights based on the 1987 distribution of houses sold replaces the old weights from 1982. Further, this aggregation includes a component for attached homes that was not included previously. The results of these changes are shown in Table D.1, which presents the regional price indexes and the national price index with the weights applied in the aggregation.

Table D.1

CENSUS REGIONAL AND NATIONAL COMP INDEXES REVISED						
	NORTHEAST	MIDWEST	SOUTH	WEST	ATTACHED	NATIONAL
WEIGHT	10.3%	34.1%	14.0%	28.0%	13.6%	
1975	35.3	46.3	43.9	41.1	47.2	43.8
1976	36.6	50.5	49.3	44.8	48.2	47.0
1977	39.1	56.6	54.0	51.9	46.7	51.5
1978	42.8	64.8	60.1	62.1	47.7	58.8
1979	49.0	72.6	69.2	72.4	57.6	67.6
1980	53.8	75.9	77.2	81.0	71.2	74.4
1981	58.4	82.9	83.9	86.1	76.9	80.6
1982	60.4	85.3	86.6	87.1	79.3	82.6
1983	64.2	85.2	89.0	88.8	85.4	84.6
1984	69.7	90.2	91.9	92.0	86.3	88.3
1985	76.7	88.7	93.8	92.7	94.6	90.1
1986	88.0	93.7	96.6	95.0	97.5	94.4
1987	100.0	100.0	100.0	100.0	100.0	100.0
1988	102.4	104.4	102.3	105.4	100.1	103.6
1989	105.5	106.8	105.2	112.0	103.9	107.5

To understand the extent of change in the price index, Table D.2 provides a comparison of the price index before and after the revision (with the old index re-based to 1987=100). In addition, a separate constant quality house price index was computed for the FHA market using the distribution of mortgages insured in 1987 rather than the Census weights of new houses sold in this period. The revised index suggests higher house price appreciation in the 1975-89 period than previously estimated. The revised index also indicates lower house price appreciation in the early 1980's and much higher appreciation since 1985. Selecting separate weights for the FHA market dampens the overall appreciation since 1975 from 150 to 143 percent, but does not appreciably change the price index from the Census revised price index even though the distribution across the four regions is markedly different as reflected in Table D.3.

Table D.2

IMPACT OF REVISION IN CONSTANT QUALITY HOUSE PRICES								
YEAR	OLD COMP	GROWTH RATES		REV. COMP	GROWTH RATE		REVISED FNA COMP	GROWTH RATE
		ANNUAL	CUM		ANNUAL	CUM		ANNUAL CUM
1975	43.5			43.0			44.2	
1976	46.9	7.7%	7.7%	46.3	7.7%	7.7%	47.4	7.2%
1977	52.2	11.3	19.8	51.5	11.3	19.8	51.8	9.4
1978	59.5	13.9	36.5	58.8	14.2	36.8	59.0	13.9
1979	68.1	14.4	56.2	67.6	15.0	57.3	68.3	15.7
1980	75.7	11.2	73.7	74.6	10.4	73.6	76.3	11.8
1981	82.8	9.4	90.0	80.6	8.0	87.6	82.3	7.9
1982	85.6	3.4	96.5	82.6	2.5	92.2	84.4	2.5
1983	88.2	3.0	102.4	84.6	2.4	96.9	86.7	2.8
1984	91.4	3.7	109.8	88.3	4.4	105.5	89.9	3.7
1985	94.2	3.0	116.1	90.1	2.0	109.7	92.0	2.3
1986	97.3	3.3	123.2	94.4	4.8	119.7	95.4	3.7
1987	100.0	2.8	129.5	100.0	5.9	132.7	100.0	4.9
1988	100.1	0.1	129.7	103.6	3.6	141.1	103.3	3.3
1989	102.7	2.7	135.8	107.5	3.8	150.2	107.4	4.0

Table D.3

WEIGHTS USED IN COMPUTING HOUSE PRICE APPRECIATION					
	NORTHEAST	HIGHEST	SOUTH	WEST	ATTACHED
CENSUS 1982	10.1	11.3	54.6	24.0	
CENSUS 1987	10.3%	34.1%	14.0%	28.0%	13.6%
FNA 1987	4.5	15.9	34.5	31.5	13.6

A. Impact on Measures of Equity and Dispersion

The analysis of claim termination employs a measure of net equity to predict the conditional probability of claim termination. Key to the net equity measure is the index of constant quality house prices. A measure of dispersion of house price appreciation is also used as a predictor for conditional claim rates. Table D.4 presents the re-computed historical dispersion of house price appreciation. The far right columns give the averages for the old and new series. Using our constructed dispersion index for house price appreciation indicates that the revised constant quality house price index has greater variability in the 1975 through 1985 period. However, from 1985 to the present, the revised index has 20 percent less variability by 1989. Overall, the average dispersion rate of the new series for the first ten policy years is about ten percent less than for the old series and for the eleventh through the fifteenth policy year is twenty percent less.

Table D.4

POLICY YEAR	HISTORICAL DISPERSION IN HOUSE PRICE APPRECIATION Across Four Census Regions Using New Constant Quality House Prices															AVERAGES	
	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988		NEW	OLD
1	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
2	2.4	3.5	3.9	1.6	3.0	1.2	1.0	2.6	2.4	5.0	5.5	4.2	1.5	1.7		2.8	3.0
3	5.7	7.5	4.8	6.5	2.5	2.1	3.1	4.5	7.0	10.5	10.1	3.9	2.9			5.3	5.6
4	9.6	8.2	6.5	3.8	2.7	3.7	5.1	9.7	13.0	15.3	9.4	4.3				7.6	8.2
5	10.1	9.5	5.4	3.7	4.8	5.7	10.3	15.7	18.2	14.5	9.1					9.7	10.7
6	11.0	8.3	4.6	5.7	6.0	10.6	16.4	21.0	17.3	16.1						11.5	12.6
7	9.9	7.3	5.2	6.5	11.1	16.9	21.7	20.1	16.8							12.8	14.2
8	9.0	6.9	5.0	11.4	16.9	22.2	20.7	19.6								14.0	15.6
9	8.0	5.9	9.1	16.8	21.9	21.2	20.2									14.7	16.6
10	6.6	8.1	14.0	21.8	20.9	20.5										15.3	17.7
11	7.1	11.8	18.7	20.8	20.4											15.8	19.0
12	9.7	16.2	17.9	20.4												16.1	20.5
13	13.8	15.7	17.8													15.8	20.6
14	13.4	15.9														14.7	19.7
15	13.9															13.9	18.7

II. RE-ESTIMATION OF THE CLAIM RATE MODEL

The conditional claim rate model was re-estimated using the revised net equity index measures and the house price dispersion measures. Table D.5 presents the statistical regression results. The key findings from this re-estimation indicate that the overall fit of the model has decreased slightly. The coefficients for net equity overall take on more negative values, indicating a lower propensity to default for a given level of equity. This suggests that for the later 1980's the effects of equity on the conditional claim probability will be lower than previously estimated. However, the impact of regional house price dispersion has increased significantly as indicated by the coefficients on the house price dispersion measure. In addition, the unemployment is of less importance across each of the LTV categories as seen with the smaller and statistically less significant coefficient estimates.

MMI FUND ANALYSIS

Table D.5

REGRESSION RESULTS FOR CONDITIONAL CLAIM RATE MODELS Six Loan-To-Value Categories						
INDEPENDENT VARIABLES	LTV 75-85%	LTV 85-90%	LTV 90-93%	LTV 93-95%	LTV 95-97%	LTV INVESTOR
Intercept	-4.096 (1.42)	-4.355 (0.84)	-0.606 (0.62)	-1.122 (0.51)	-0.159 (0.32)	-0.856 (0.72)
POLICY YEAR:						
TWO	3.685 (1.26)	2.971 (0.72)	-0.406 (0.53)	0.293 (0.45)	-0.549 (0.28)	0.479 (0.63)
THREE	4.953 (1.23)	3.879 (0.70)	0.614 (0.52)	1.296 (0.43)	0.420 (0.27)	1.489 (0.61)
FOUR	5.246 (1.22)	3.928 (0.68)	0.859 (0.50)	1.507 (0.42)	0.627 (0.26)	1.683 (0.60)
FIVE	4.990 (1.20)	3.475 (0.67)	0.622 (0.49)	1.320 (0.42)	0.431 (0.26)	1.440 (0.59)
SIX	5.179 (1.19)	2.858 (0.67)	0.527 (0.49)	1.159 (0.41)	0.191 (0.26)	1.348 (0.59)
SEVEN	4.819 (1.19)	2.806 (0.67)	0.224 (0.49)	0.923 (0.41)	0.030 (0.26)	1.078 (0.59)
EIGHT	4.571 (1.20)	2.064 (0.67)	-0.027 (0.49)	0.649 (0.41)	-0.184 (0.26)	0.712 (0.59)
NINE	3.926 (1.20)	1.907 (0.67)	-0.294 (0.49)	0.531 (0.41)	-0.249 (0.26)	0.597 (0.59)
TEN	4.309 (1.20)	1.775 (0.67)	-0.895 (0.49)	0.397 (0.41)	-0.350 (0.26)	0.263 (0.59)
ELEVEN	3.510 (1.21)	1.258 (0.68)	-0.484 (0.49)	0.283 (0.42)	-0.276 (0.26)	0.127 (0.60)
TWELVE	2.266 (1.24)	0.263 (0.69)	-0.494 (0.50)	-0.056 (0.42)	-0.200 (0.26)	-0.317 (0.61)
THIRTEEN	3.362 (1.28)	1.005 (0.71)	-0.186 (0.51)	0.033 (0.43)	-0.169 (0.27)	-1.036 (0.63)
FOURTEEN	2.099 (1.39)	-0.031 (0.77)	-1.016 (0.56)	-0.609 (0.47)	-0.138 (0.29)	-1.382 (0.68)

Table D.5(Cont'd)

INDEPENDENT VARIABLES	REGRESSION RESULTS FOR CONDITIONAL CLAIM RATE MODELS Across Six Loan-To-Value Categories					
	LTV 75-85%	LTV 85-90%	LTV 90-95%	LTV 95-97%	LTV 97-99%	LTV INVESTOR
EQUITY:						
OVERALL	-5.286 (0.86)	-3.269 (0.49)	-2.665 (0.73)	-3.097 (0.59)	-2.412 (0.38)	-4.579 (0.39)
PRE 1979 PERIOD ONLY (1975-99=1, 1978=0.5)	-3.173 (0.51)	-1.489 (0.34)	-2.369 (0.78)	-1.947 (0.62)	-2.193 (0.40)	0.053 (0.27)
EQUITY(t-1) post 1978	.	.	-1.280 (0.82)	-0.899 (0.67)	-1.673 (0.43)	.
EQUITY BY SIZE CATEGORY						
ONE	2.713 (0.51)	3.545 (0.38)	2.920 (0.29)	2.575 (0.21)	1.991 (0.12)	2.084 (0.26)
TWO	.	1.543 (0.41)	1.251 (0.32)	1.506 (0.23)	1.130 (0.12)	1.587 (0.29)
SEVEN	-2.189 (0.72)	-3.415 (0.40)	-1.513 (0.27)	-6.365 (0.40)	-5.830 (0.43)	-3.606 (0.40)
PRE 1978 PERIOD ONLY						
UNEMPLOYMENT RATE (t-1)	0.011 (0.06)	0.085 (0.04)	0.078 (0.03)	0.082 (0.03)	0.119 (0.02)	0.080 (0.03)
HOUSE PRICE DISPERSION	8.703 (2.47)	15.888 (1.68)	8.631 (1.25)	8.296 (1.01)	6.279 (0.64)	7.461 (1.33)
SUMMARY STATISTICS						
Adjusted R-Square	0.575	0.683	0.710	0.777	0.840	0.677
Root Mean Squared Error	74.075	62.169	50.314	47.546	41.022	48.020
F-Statistic	52.852	79.225	85.547	121.783	182.858	77.036
Number of Observation	728	728	728	728	728	728

III. FORECASTING CLAIM RATES WITH THE NEW MODEL

In evaluating the performance of the re-estimated claim rate model using the revised constant quality price index, the simulation analysis on loan performance through 1989 is performed and an ex-ante forecast across all policy years for the recent loan origination years is made.

A. Simulation of Claims

The results of the dynamic simulation analysis are shown in Tables D.6 and D.7. Exhibits A.8 and A.9 in Appendix A present similar results for the original index. These results indicate that the overall predictive performance of claims has diminished slightly -- the overall predictive performance of claims is 96 percent for the original index compared to 95 percent for the revised index.

Table D.6

DYNAMIC SIMULATION OF CLAIMS AND PREPAYMENTS FOR THE PERIOD 1979-89							
LOAN SIZE	LTV CATEGORY	Across loan size and LTV Category			PREPAYMENT		
		ACTUAL	PREDICTED	ERROR	ACTUAL	PREDICTED	ERROR
	75-85%	13,790	14,375	(585)	99,603	83,054	16,549
	85-90%	20,488	20,810	(322)	104,732	96,599	8,133
	90-93%	25,137	23,472	1,665	92,983	92,998	(15)
	93-95%	44,871	42,421	2,450	113,035	104,186	8,849
	95-97%	90,120	84,360	5,760	180,114	168,667	11,447
	Investor	37,326	34,717	2,609	119,002	112,080	6,922
1		44,907	44,099	808	66,091	65,079	1,012
2		29,001	27,694	1,307	65,050	65,785	(735)
3		31,434	28,513	2,921	87,824	79,858	7,966
4		31,448	28,166	3,282	97,862	94,582	3,280
5		29,803	27,685	2,118	102,856	91,686	11,170
6		47,041	42,659	4,382	181,444	174,571	6,873
7		18,098	21,539	(3,441)	108,362	86,004	22,358
TOTALS		231,732	220,355	11,377	709,460	657,565	51,904

Table D.7

DYNAMIC SIMULATION OF CLAIMS AND PREPAYMENTS FOR THE PERIOD 1979-89							
Across Loan Origination and Termination Year							
ORIG YEAR	TERM YEAR	CLAIMS			PREPAYMENT		
		ACTUAL	PREDICTED	ERROR	ACTUAL	PREDICTED	ERROR
	79	-	-	-	580	459	-
	80	1,020	901	119	2,430	1,526	904
	81	3,725	2,901	824	3,349	2,480	869
	82	7,054	4,810	2,244	2,142	3,947	(1,805)
	83	13,270	10,065	3,205	31,452	39,133	(7,681)
	84	15,373	15,838	(465)	22,203	22,024	179
	85	21,548	18,252	3,296	32,759	43,731	(10,972)
	86	28,750	31,753	(3,003)	181,663	224,825	(43,162)
	87	39,931	42,750	(2,819)	247,279	173,341	73,938
	88	51,652	51,427	225	100,999	75,049	25,950
	89	49,409	41,638	7,771	84,613	71,051	13,562
79		18,470	19,921	(1,451)	59,114	54,689	4,425
80		24,940	24,526	414	66,772	82,555	(15,783)
81		27,704	20,967	6,737	68,231	98,249	(30,018)
82		19,053	14,152	4,901	60,834	67,159	(6,325)
83		43,156	48,902	(5,746)	162,278	149,166	13,112
84		28,083	26,437	1,646	95,323	80,223	15,100
85		30,713	26,629	4,084	119,266	63,002	56,264
86		28,565	24,489	4,076	59,214	39,344	19,870
87		11,048	14,331	(3,283)	20,457	23,178	(2,721)
TOTALS		231,732	220,355	11,377	709,460	657,565	51,904

B. Forecasting Claim Rates with Revised CQHP Appreciation Assumptions

In forecasting conditional claim rates for policy years beginning in 1990, a baseline forecast for the revised constant house price index is needed. The original baseline forecast for CQHP of 3.25 percent was tied to the recent history of CQHP appreciation. Because the revised index indicates higher appreciation in recent years, the baseline forecast is raised to 4.5 percent. The assumption for regional dispersion in house price appreciation will remain the same at 90 percent of the (new) historical average dispersion.

Tables D.8 through D.10 compares the new and old forecast results for the ultimate conditional claim rates for the recent historical period form 1986-89 and for the test policy year 1990 under the revised baseline forecast assumption for CQHP.

Table D.8

FORECAST OF CONDITIONAL CLAIM RATES 1986-90 Old and New Estimates for Ultimate Claim Rates Assuming Baseline Economics					
	1986	1987	1988	1989	1990
OLD	12.03%	11.67%	13.60%	13.57%	12.57%
NEW	11.09	10.99	13.25	13.46	12.43

Table D.9

1990 FORECAST OF CONDITIONAL CLAIM RATES BY LTV Old and New Estimates for Ultimate Claim Rates Assuming Baseline Economics								
	<75%	75-85%	85-90%	90-95%	95-99%	99-97%	>97%	TOTAL
OLD	6.92%	6.30%	5.38%	10.68%	11.94%	17.74%	19.34%	12.57%
NEW	6.97	6.27	6.10	10.67	11.86	17.66	19.07	12.43

Table D.10

1990 FORECAST OF CONDITIONAL CLAIM RATES BY LOAN SIZE Assuming Baseline Economics								
	\$0-40K	\$40-48K	\$48-56K	\$56-64K	\$64-72K	\$72-88K	\$88-105K	>\$105K TOTAL
OLD	19.23%	15.37%	12.12%	11.89%	11.77%	11.46%	11.02%	9.66% 12.57%
NEW	20.81	15.58	11.51	11.32	11.22	10.95	10.56	9.39 12.43

MMI FUND ANALYSIS

IV. FORECASTING THE FINANCIAL POSITION OF THE MMI FUND

The baseline forecast of claim and prepayment rates is then used to project the financial performance of both the existing and new business. Exhibit D.11 presents the net present value of each years business (in FY1988 dollars) under the old and new house price indices.

Table D.11

NET PRESENT VALUE OF BUSINESS Assuming Baseline Economics		
	OLD INDEX	NEW INDEX
1975	\$240	\$240
1976	283	279
1977	429	429
1978	521	519
1979	435	425
1980	(241)	(251)
1981	(801)	(804)
1982	(628)	(621)
1983	(886)	(817)
1984	(791)	(745)
1985	(874)	(731)
1986	(379)	(219)
1987	(186)	(61)
1988	(294)	(260)
1989	(283)	(275)
1990	(208)	(194)

As illustrated, the overall performance of the Fund is similar under both indices. The above numbers translate into a market value of the Fund including 1990 business of \$2.4 billion under the old index compared to \$2.9 billion the new index. The values of (new) 1990 business are extremely close.

In addition to analyzing a baseline scenario, we also analyzed an adverse scenario for the new index. This scenario assumes constant quality-adjusted house price appreciation of 3.5 percent, a loss ratio of 40 percent, and severe dispersion ranging from 100 to 130 percent of the average between 1975 and 1989. Under such a scenario, the market value of the Fund including 1990 business is \$0.18 billion compared to -\$0.43 billion under a similar scenario for the old index.

Price Waterhouse
D-9

SPECIAL CASE: 30-YEAR MORTGAGES (EXACTLY 95% LTV RATIO)

CONDITIONAL PRE-PAYMENT PROBABILITY (%)

FISCAL YEAR (AMORTIZATION OF LOAN)

POLICY YEAR	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1														0.75	1.11
2														2.41	
3															
4															
5															
6															
7															
8															
9															
10															
11															
12															
13															
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15															